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**Approaches to self-regulation of microfinance
organizations: the case of Russia**

Master's Thesis by the 2nd student
Concentration – International Business
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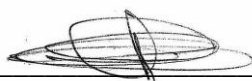
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ЗАЯВЛЕНИЕ О САМОСТОЯТЕЛЬНОМ ХАРАКТЕРЕ ВЫПОЛНЕНИЯ ВЫПУСКНОЙ КВАЛИФИКАЦИОННОЙ РАБОТЫ

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АННОТАЦИЯ

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Описание цели, задач и основных результатов	<p>Цель исследования состоит в изучении возможности разработки подходов к саморегулированию для микрофинансовых организаций.</p> <p>Для достижения этой цели были установлены следующие задачи:</p> <ul style="list-style-type: none"> - изучить теоретические основы саморегулирования - определить диапазон потенциального неэтичного поведения микрофинансовых организаций, нуждающихся в регулировании - изучить основные международные тенденции регулирования и саморегулирования в микрофинансовой отрасли - выявить основные этические проблемы российской микрофинансовой отрасли, которые могут потребовать регулирования - оценить подходы саморегулирования в российской микрофинансовой отрасли. <p>Результаты проведенных интервью и онлайн-опроса среди участников отрасли показали, что наиболее распространенными неэтичными практиками российских микрофинансовых организаций, которые нуждаются в регулировании, являются: недобросовестная практика кредитования, высокие процентные ставки, отсутствие прозрачности в условиях кредитования, отсутствие гибкости и агрессивный маркетинг со стороны микрофинансовых организаций.</p> <p>Исследуя подход к саморегулированию микрофинансовой отрасли в России, результаты исследований показали, что сбалансированный подход является наиболее эффективным, что подразумевает совместное и усиленное регулирование отрасли саморегулируемыми организациями и Банком России.</p>
Ключевые слова	Микрофинансовые Организации (МФО), Микрокредитование, Неэтичное поведение МФО, Этические проблемы, Саморегулирование, Регулирование

ABSTRACT

Master Student's Name	Hayk Grigoryan
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Description of the goal, tasks and main results	<p>The goal of the current research is to explore the possibility of developing approaches to self-regulation of Microfinance Organizations.</p> <p>To achieve this goal, the following tasks have been set:</p> <ul style="list-style-type: none"> - to study theoretical background of self-regulation - to determine a range of potential unethical behavior of Microfinance organizations that need regulation - to study main international trends of regulation and self-regulation in microfinance industry - to reveal the main ethical issues of Russian microfinance industry that might need regulation - to evaluate the approaches of self-regulation in Russian microfinance industry. <p>The results of conducted interviews and online survey among participants showed that the most common unethical practices by Russian microfinance organizations that need regulation are: unscrupulous lending practices, high interest rates, lack of transparency on loan conditions, lack of flexibility and aggressive marketing by microfinance organizations.</p> <p>Regarding the approach to self-regulation of microfinance industry in Russia, research results revealed that balanced approach is the most effective, which implies jointed and coordinated regulation of the industry by Self-Regulated Organizations and Bank of Russia.</p>
Keywords	Microfinance Organizations (MFOs), Microlending, Unethical behavior of MFOs, Ethical issues, Self-Regulation, Regulation

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Introduction

In today's fast-growing world, the crises and the failures of economic policy run by governments in many countries are very common and very often unfavorable for ordinary people, who live at or under minimum living wage. Russian citizens are not an exception, and most of them live so called "under debt".

Every day the market of goods and services proliferates with various goods, commodities, however not all people can afford to have what market offers. In this situation lots of Russian citizens went to commercial banks to get money for desired furniture, electronic device, automobile or for just necessary money to have a good vacation abroad. However, after all the financial and economic crises that Russia crossed, clear majority of these people, due to decreased incomes, were financially unavailable to return the taken loans on time, hence finding themselves in "black" lists of the banks.

Later, because of inferior credit histories, banks began to lend less and less money to these people, who afterward started to find alternative sources of financing. As most Russians do not possess extra money for peer lending, microcredit organizations (hereinafter MFOs) became more active, and microfinance market bloomed in Russia.

Also, after Soviet Union breakdown, in a new economic reality the role of small and medium business became crucial for economic growth. However, while in western developed countries share of SME is 60-70% of GDP, in Russia it barely reaches to 15-20% level. Most of small entrepreneurs that start their business need financing from outside, but not having a collateral and credit history leave them out of bank-lending. The only thing that all these people can do to accomplish their business ideas and survive the "death stage", is to find other sources of financing. And, again microfinance organizations leave a hand to all these desperate people.

Currently, microfinance organizations in Russia are of high importance, and regulation and supervision of these organizations is very hot topic. The industry is growing since 1990s and nowadays, perhaps nobody doubts about the important role of these organizations in financial market and in enhancement of financial inclusion in the country. However, the attitude of many citizens toward these organizations is not always positive, rather it is malevolent due to the unscrupulous lending practices, so called "usury" interest rates charged by some MFOs, high indebtedness of citizens, unscrupulous collection practices, etc.

Until 2011 such organizations in Russia were not directly regulated, but rather were operating according to Civil Code of Russia and some other federal laws not straightly related to microfinance activities. The law "on Microfinance Activities and Microfinance Organizations" was issued in 2010, after which the activities of microfinance organizations standardized, and

Bank of Russia became the mega-regulator of the industry. A few years later, the law on “Self-regulated organizations in financial market” came to existence, and all MFOs membered to self-regulated organizations (hereinafter SROs).

After the law on microfinance organizations imposed, year by year Bank of Russia imposes stricter and stricter limitations and normative acts on these organizations, which put the latter’s sustainable growth under risk. There is a non-official opinion circulated in various levels of regulatory bodies, that SROs and MFOs were not able to effectively self-regulate and self-organize the industry, and that Bank of Russia had to take the rule and regulate the industry.

So, there is a real problem for further research to understand: (1) what are the current ethical issues of the industry that bring to “strict” state regulation, and (2) if SROs and MFOs aren’t able to manage with self-regulation, to figure out whether there are more effective approaches to self-regulation of the industry or not.

Therefore, the goal of the current research is to explore the possibility of developing approaches to self-regulation of microfinance organizations.

To achieve this goal, we have set the following objectives:

- to study theoretical background of self-regulation
- to determine a range of potential unethical behavior of MFOs that need regulation
- to study main international trends of regulation and self-regulation in microfinance industry
- to reveal the main ethical issues of Russian microfinance industry that might need regulation
- to evaluate the approaches to self-regulation of Russian microfinance industry.

Chapter 1. Regulation of Moral Issues in Microfinance Industry: Theoretical Framework

In this chapter we are going to build the theoretical framework for explanation of regulation in microfinance industry. In section 1.1 we will discuss the general theory of ethical behavior in the market economy and the limits of markets in removing unethical behavior. While doing this we will step by step apply this theory to microfinance sector will end up with potential situations of unethical behavior in this area. In section 1.2 we will provide a literature survey of other scholars' opinions on these issues and will check our framework for consistency. In section 1.3 we will review existing approaches to regulation and self-regulation of ethical behavior in the market. Finally, in section 1.4 we will review the main types of regulation in microfinance industry.

1.1. Moral issues in microfinance sector

Many economists believe that in perfectly competitive market moral judgements are not necessary. The rationale behind this thesis is that perfectly competitive markets remove all issues about efficiency and morality. The efficiency of markets terminates in the accomplishment of optimality, a point in which conflicting interests are pleasingly reconciled by the invisible hand (Andreicut 2010). Going back to Adam Smith, economics approves the view that each participant gains maximum while pursuing his individual self-interest to market activity (Sutherland 1998). In the scope of free market economics, morality appears to be unessential.

In his work of "Morals by Agreement" (1986), David Gauthier also develops the idea that free market activity, in the absence of market failures, brings about optimal outcomes for the participating individuals. He continues to contend that a perfectly competitive market is a *morally free zone*.

Generally, Gauthier's thesis tries to derive morality from rationality. He believes that an individual is acting rationally if and only if she pursues "her greatest interest or benefit" (Gauthier 1987, page 135). Also, an individual does this by maximizing her utility in line with her preferences.

As a basis for his thesis, Gauthier uses the notion of Pareto optimality. Storchey (2015) also takes the First Theorem of Welfare Economics to prove that perfect competition eliminates moral and efficiency issues. He states that under perfect competition, allocation of resources is Pareto-efficient, which means that it is impossible to increase the total product by reallocation of

any resource. In other words, at Pareto efficiency the only way to make someone better off involves making someone else worse off.

Finally, Storchevoy states that this thesis might be also justified by the fact that under perfect competition, everyone received the same output for the same type of input, since movement of resources will exclude unfair compensation very quickly.

To understand whether perfect competitive market is ethical and what is moral issue, we will adhere again to the concept of Storchevoy (2015). He defines moral issues as a situation of choice which increases the well-being of one person and decreases the well-being of others. Going further, the author explains why not all actions might be considered as moral issues. First, if an action affects only one actor it is not a moral issue, since all moral issues are about social interaction of people. Also, if an action brings to pareto-optimality increasing well-being of all parties or vice versa, it cannot be a moral issue. As in business this kind of pure win-win is happened very rarely, Storchevoy generalizes that moral issues are formally a win-lose situation.

Then, the author defines main characteristics of perfect competition, which are: (1) many small buyers and sellers; (2) perfect mobility of all people, products, and resources; (3) perfect divisibility of all products and resources; (4) all people have equal capabilities; (5) all people are neutral to each other; and (6) all people are fully rational and not bound by any cultural or social norms.

Competitive markets may be understood as completely ethical if all people have the same opportunities. However, there are vulnerabilities such as *market power*, *asymmetry of information*, *personal differences*, and *non-neutrality* that make difficult to analyze every type of moral issue (Storchevoy 2015). In microfinance market some of these vulnerability factors may be extremely strong, while the others may be very weak.

Market power exists when one of the first three characteristics is not valid. For example, there are few buyers and sellers, mobility is not perfect, or imperfect divisibility of products. In microfinance, market power may be rather small if there is a strong competition between MFOs. If there is large number of firms the competition may be very effective.

One demonstration of this vulnerability in microfinance market is that in many cases people urgently need money and accept the first option, because they cannot wait and search for a better option. As we know, especially in developing countries target group for microfinance services mainly consists of low income individuals, who face various difficulties in their everyday life. These people, due to different circumstances, very often admit the first offer and stay out of choice. Similarly, in many rural regions, where the financial inclusion is very low, people have very limited opportunities to choose among different providers of financial services due to lack of represented financial institutions.

Also, we can explain the existence of market power in microfinance market with *tie-in pricing* technique. Although interest rates offered for microloans are quite higher than that's of standard banks, however, lots of people are willing to take these loans since in short period of time high interest rates are not so tangible for them. But microfinance organizations very often impose on people other mandatory expenses such as loan insurance, high fines for arrears, extra fees for loan restructuring and prolongations, and other paid options as well. This kind of tying, especially by contract, very often is regarded as anti-competitive practice, since customers are harmed by being forced to purchase a good that they don't want to buy actually.¹

Finally, we can also identify market power in microfinance as a hold-up situation. This happens when clients sign contracts after which it is impossible to change. This issue is very specific to microfinance market, as very often MFIs are accused not revealing the whole information on loan conditions to clients. Instead they attract customers, who sign contracts without paying attention to the details and later they find themselves locked within these contracts. This practice of "polite fraudulent" is used by many MFIs, the fact that pushes regulators to issue different legislations trying to force MFIs to depict the main conditions regarding the amount of loan, interest rates, terms, fines and penalties on more notable ways in loan contracts (on first pages, with large fonts).

Asymmetric information, also known as information failure, happens when one party possesses greater material knowledge than the other party. For instance, when the seller of a good or service has greater knowledge than the buyer, even though vice versa is also possible. Almost all economic transactions involve information asymmetries.²

In certain situations, asymmetric information may lead to adverse selection or moral risk. These are situations where individual economic decisions are theoretically worse than they would have been had all parties possessed more symmetrical information.

Asymmetry of information in microfinance market might be very strong and two-sided.

From one side, the borrowers might demonstrate unethical behavior by taking money from microfinance institutions well knowing that there will be low chances to return loans. Even worse, some swindlers-borrowers knowing well the loopholes of civil code and legislation, after first the payment stop to repay the loan and disappear as a rule. Finally, there are ones that exposing themselves as a conscientious and solvent citizen, take money and disappear from MFIs' field of vision. This is taken place, as a rule, due to the adverse selection and not efficient assessment process of lenders.

¹ Resource available at [https://en.wikipedia.org/wiki/Tying_\(commerce\)](https://en.wikipedia.org/wiki/Tying_(commerce))

² Resource available at <https://www.investopedia.com/terms/a/asymmetricinformation.asp>

From the other side, sometimes microlenders are also engaged in unethical behavior while hiding some information about terms of the contract. In most cases MFOs do not disclose the essential characteristics of the proposed product (such as penalties, repayment scheme, possibility of extension or early repayment, etc.). This information is either provided in the general terms and conditions (conditions) of the loan (this document is usually posted on the company's website on pages of the third or more level, which makes it very difficult for the borrower to find it) or is absent altogether. The website also does not contain the text of a standard agreement with a microfinance organization – a borrower can familiarize himself with it only in the office and only at the stage of signing the contract.

Different capabilities can also distort the balance between market actors leading to bad outcomes. In high competitive market, some people due to their smartness, agility could benefit more than people with limited capabilities. When this differentiation is high, slightly different capabilities not only modify moral issues but also tastes and correspondingly demand for goods and services as well.

In microfinance market, difference in capabilities of actors are very common, especially from customer side. As a rule, vast majority of borrowers of microloans are financially illiterate and lack technical knowledge. This is the perfect inability to plan savings and investing for the future, inability to make financial decisions in simple life situations and as a result - assuming unjustified risks.

Borrowers of microcredits also lack of will or rationality to avoid from temptations. Thanks to the active publicity and advertisement, the public has formed the idea of credit as a solution to all problems and at the same time there is no natural understanding for financially literate people that loans are financial service for not everyone (Solodukhina 2015, p.142). If a person cannot afford a loan, then he does not need such a loan or any kind of loan.

Also, many borrowers are not able to plan their future. In the absence of proper self-control or negative experience, a person is involved in loan trap taking new ones to repay old ones.

So, different capabilities lead not only to a decrease in the efficiency of the household economy, but also to a general decline in competition in the financial sector, as the provider of financial products and services does not need to take any measures to increase the competitiveness of its own products.

Non-neutrality or discrimination in the market means that some actors might have different sympathies and attitudes toward others. This kind of mutual discrimination might distort perfect competition in the market and requires reassessment of moral norms (Storchevoy 2015, p.140).

Regardless, it is theoretically possible to have some kind of discriminative interaction between service providers and borrowers in microfinance, however, we will not take this externality into our analysis due to its negligible actuality in microfinance. Indeed, in some cases, managers or agents of some MFOs could enter in some discriminative lending practices, but this kind of practices are very rare among fair players and not specific to the industry in general.

Therefore, we may expect the next moral issues in the relationships between microfinance institution(MFI) and its clients:

- market power abuse in case of
- small number of MFIs relatively to demand
- poor awareness of customers about available MFIs
- tie-in and hold-up effects
- asymmetry of information about the terms of the contract (small fonts, complicated language, customer unwillingness to examine the contract, etc.)
- non-caring about the customers who cannot make their own rational choice about borrowing money because they have lack of financial skills or weak will.

1.2. Extant research of ethics in microfinance

In this section we will try to check how the existing literature conceptualize the moral issues in microfinance institutions and will compare these views with the framework suggested in section 1.1.

While some sceptics jokingly refute that there is no any ethics in finance and microfinance in particular³, however, a rational thought reveals that finance would be impossible without ethics and morality. The fact that we all place our assets in the hands of other people and are in relationship with financial institutions, requires enormous trust between us and these institutions. To support the mutual trust, both customers and microfinance institutions should follow the rules of ethics, anchor to more responsible business practices and exclude the possibility for some people to gain at other's expense.

Individuals in positions of management must make the decision every day whether or not to act in an ethical manner. Deciding what is considered right or wrong ethically, is not always black and white. Many times, managers find themselves pushing the limits and entering the grey area of ethics. De Cremer and de Bettignies (2013) explain that in the business environment there

³ This view expressed especially in a thin volume, *The Complete Book of Wall Street Ethics*, which claims to fill "an empty space on financial bookshelves where a consideration of ethics should be."

are many implicit expectations and norms that motivate managers and ultimately may push them to cross the boundaries and behave unethically. Very often, competitiveness and greed could push managers into the ethical grey area.

According to De Cremer and de Bettingnies (2013), “This attitude of pushing the limits effectively clouds our own moral limits and, as a result, increases the chances that we eventually will cross the boundaries” (p. 65). Many managers believe if they are not doing anything illegal, they are acting ethically. This is not always the case; therefore, it is important for managers to understand the difference between laws and ethical standards. Once managers have a fair understanding of what is considered appropriate ethical behavior, they can focus on making good ethical decisions for the organization.

Regarding the relationship between laws and ethical standards, Keller-Krawczyk (2010) explains that laws are rules of conduct set by a governing body that either requires or prohibits individuals or businesses from performing certain actions. Failure to comply with the set laws may result in punishments such as financial penalties and/or imprisonment. As mentioned previously, it is not uncommon for individuals to believe that if they are operating within the boundaries of the law, then they are behaving ethically. Unfortunately, there are many actions that may be considered legal, but are not considered ethical. Keller-Krawczyk support this notion stating that usury (charging high interest rates in countries that do not set a legal limit on rates) is a good example of a behavior that is legal but also considered unethical. Business managers must attempt to understand the relationship and differences between laws and ethics if they wish to help implement ethics within their organization.

Managers are often aware of the laws and regulations because they are formally written and failure to comply with them will result in some sort of sanctioned punishment, whereas ethical standards are socially construed and failure to comply with these standards is not always punishable under state or federal sanctions. Cameron (2011) explains that ethical standards do not always serve as adequate fixed points for managers because they “often change over time and circumstance” thus they “frequently do not remain stable because they are socially construed”.

Although laws and regulations are different than ethical standards, managers need to understand how the two can be integrated and used within their organization to help build a solid ethical foundation. Blodgett (2012) acknowledges that many philosophers and legal scholars have attempted to explain the complicated relationship that exists between laws and ethics and although it is still not easily understood, it is evident that there is indeed a connection between the two. A study conducted by Blodgett (2012) explored the idea of “substantive ethics” (an integration of law and ethics) and how it could be applied to corporate governance as well as the managerial decision-making process.

Basically, microfinance institutions are very often characterized as having dual mission: from one side to do good (increase the social outreach of credit) and to do well (achieve financial sustainability) (Battilana & Dorado, 2010).

In recent years, however, more and more critics is directed to the microfinance industry, and undeniably many scholars nowadays emphasize that there is really “ethical crisis” in the field (Hudon and Sandberg, 2013). The debates on the topic of ethical crisis in microfinance started actively after 2007, when one of Mexican MFIs, which started its business from lending to poor people, went open in stock market offering its first IPO (Lewis, 2008). After, other MFIs have been accused in exploitative lending practices, unlawful and unethical loan collection tools, “forcing” borrowers into indebtedness, etc.

In addition, the delinquency crises in its turn also darkened the impact of microfinance on clients and, alongside, the academic dispute provided evidence supporting the lack of impact of the microcredit programs on poverty reduction flourished (Banerjee et al, 2015). Thereafter, the wave of distrust toward microfinance and organizations engaged in microlending, ascended in different countries simultaneously.

Going through the theory we can state that different authors tried to define the interdependencies and the relations taking place between ethics and microfinance.

Vanroose (2007) distinguishes three paths along which ethics integrated into economics:

1. the first path refers to the situation in which economists, by following their own ethical values, influence the way of practicing economics,
2. the second path is based on the assumption that ethical values adopted and accepted by economic entities, help them by influencing their behavior,
3. the third path indicates that economic institutions and economic policy represent factors exerting diverse impacts on people and thus ethical judgments and opinions presented along with economic standpoints and assessments are so important. The author then generalized that the above outlined multidimensional relationships between ethics and economics also can be used to explain the connections between ethics and microfinance.

At this point, as Adamek (2014) noted, microfinance can be observed as the manifestation of a specific economic activity formula which by assumption, alongside offering specialized financial products with non-finance services both to the poor and micro-entrepreneurs, allows implementation of such goals as simplifying and spreading access to financial resources, promoting entrepreneurship and, in consequence, creating the background for collecting and multiplying additional savings, hereafter ultimately establishing a sense of economic safety and stabilization.

Then Vanroose, banking on the already presented paths along which ethics enters economics, formulated the possibility to identify three areas of ethics and microfinance interpenetration in this way: (1) the influence of ethical values to the broadly understood microfinance, their institutions, products and environment, (2) the impact of accepted ethical values, observed as the framework influencing the model for performing microfinance activities along with the operational nature of their products, (3) the effect of ethical values, accepted by stakeholders, on the process of evaluating the basics, methods and results of microfinance activities referred to as the element of economic, socio-welfare policy at micro and macro scale.

However, we should notice, that the aforementioned areas of ethics and microfinance interpenetration sometimes overlap and, at the same time, create space where occurring ethical dilemmas (related to the theory-practice integration) find their definitions.

Regarding this M. Hudon and J. Sandberg (2013, p. 562) indicate three vital ethical issues related to microfinance. They stance questions referring to whether a) microfinance activities are justified, b) how they should function (whether microfinance institutions exploit poor clients) and c) who should perform microfinance activities?

Regarding the first question, whether microlending is justified, we should consider the economic (cost coverage) and social (outreach) dimensions of microfinance activities.

Microfinance has an economic dimension and, it is rational that it be required to show efficiency in its management in form of costs-earning a profit. However, it is also a tool for social policies and some “welfarists” argue that it should subordinate its strategies and policies to its social function, which means to offer the best possible service at a price that is affordable by the greatest number of people (particularly poor) although it might mean to stay dependent on donations and subsidies (Argandona 2009).

From the other side, some “institutionalists”, while admitting the importance of the social function of MFI, argue that financial self-sufficiency is a necessary condition for the MFI to survive and broaden their activities reaching to more clients, as its social function requires. Moreover, these authors believe that both goals should go alongside at least in the medium term.

Hence, these contradicting positions rose a loud debate among scholars, who tried to find common opinions toward the two dimensions of microfinance institutions. A main part this debate between institutionalists and welfarists is related to very high interest rates charged by the MFIs.

According to Argandona (2009), there are three economic and ethical issues that should be answered regarding the argument of extra high interest rates: 1) whether these high rates are justified 2) What should be the interest rate stipulated for each operation? 3) If, as seems logical, a high interest rate discourages the poorest clients, does this give rise to a moral duty for the MFI?

Recent research approves that interest rates on microloans are consistently much higher than those offered by standard commercial banks, even in developing countries (Hudon M, Sandberg J., 2013). From the Microfinance Information Exchange (MIX) database we can see that typical annual rates range between 20 and 70 percent, with an overall average of about 30-35 percent.⁴ However, these figures do not give any justified answer to whether such interest rates are exploitative or not. Hudon and Sandberg believe that several important issues should be discussed thoroughly before answering 70% interest rate charged by microfinance institutions (hereinafter MFIs) is ethical or not. The authors go further stating that first issue is to understand how clients will be affected by high interest rates.

The next important issue within this context is what are the drivers behind comparatively high interest rates on microloans. To put it differently, it is only stockholders' high expectation from their investments or there are other factor laying behind high interest rates. Here, according to Hudon & Ashta (2013), the fairness of an overall microcredit depends on where the money goes, or whether a substantial portion of the interest yield was extracted from MEIs and transfer as dividends to shareholders.

About high interest rates, as well as, other issues common in microfinance industry more comprehensive and specific evaluations are given in the reports of CGAP (the Consultative Group to Assist the Poor). CGAP is a global partnership of more than 30 organizations such as The World Bank, African Development Bank (AfDB), Citi Foundation, European Investment Bank (EIB), European Commission, Inter-American Development Bank, International Finance Corporation, KfW Bankengruppe, ministries of different countries and other financial organizations. As CGAP stated "it develops innovative solutions through practical research and active engagement with financial service providers, policy makers, and funders to enable approaches at scale".⁵ So, the regular reports and guidelines by CGAP are highly valued by the researchers, practitioners, government officials, financial market representatives and etc.

GCAP report (2012) suggests that almost 80 percent of a typical MFI's income covers two types of costs: operating expenses and the cost of funds. From one hand, the operational costs are unusually high due to that fact that MFIs typically administer vast number of microloans, which generally requires face-to-face interaction with borrowers. From the other hand, the cost of funds is usually very high because MFIs seldom founded by its clients, instead take investment from commercial high price sources.

⁴ Source from Rosemberg 2013

⁵ <http://www.cgap.org/about>

Hence, Hudon and Sandberg (2013) explain that even if an average MFI will cut out all its profits, it could only reduce the interest rate by roughly one-seventh, which again proved the notion that interest rates for microloans are not due to desire earn higher profits, but rather to cover high operational costs.

Another major issue related to abuses of high interest rates charged by MFI, is the consent of clients. Interestingly, in many countries states, under pressure of politician, usually force MFIs to reduce so called “exploitative interest rates” (Hubka and Zaidi 2005), even though these interest rates are justified both ethically and economically. Moreover, very often clients are willing to pay these high rates. Remarkably, many supporters of microfinance reply to the criticism of exploitative interest rates with an argument that appeals precisely to clients' accord. Here, again, various authors have different point of view not only on the act of consent by clients, but rather analyzing the process of consent of high interest rates by clients in theoretical and practical dimensions.

As an example, Sandberg states in his article from 2012, that “researchers need more solid empirical evidence on the impact of various microfinance initiatives before accepting them”. Arnold and Valentin's (2013) supplemented this idea concluding that “ultimately must depend on whether businesses enhance or undermine the capabilities of the poor”.

Hodon and Sandberg, summarizing their analysis, agreed that generally high rates are justified and added that if some clients cannot afford cost-covering interest rates, it is not the fault MFI but that's of public bodies who should issue subsidies to help MFIs decrease their prices or to help these citizens in other ways.

Summarizing our review on recent criticisms of exploitative high interest rates charged by MFIs, we should confirm, that majority of the scholars agree that a more deeper investigation is needed to be able to generalize the statement of “exploitative microlending”. Authors such as Sandberg, Adamek, Wong, Richards, etc., stick to the position that it is not wise to generalize and attribute existing ethical problems to the whole microfinance sector. Moreover, majority of researchers agree that few cases of exploitative microlending practices cannot compromise the whole industry and hide the objective reasons of high interest rates due to high operational and funding costs combined with clients' assumed level of tolerance. Therefore, in our analysis of Russian microfinance market we will need to pay special attention to distinguishing objective reasons of high interest rates and objective proof of exploitative practices.

1.3. Theoretical approaches to self-regulation of market participants

Starting to review of literature on self-regulation of market, we should agree with Petrov's idea (2013) that when determining the boundaries of self-regulation, one should take into account that state regulation of economy can be realized in several ways: (1) direct government regulation; (2) by quasi-regulation; (3) self-regulation; (4) joint regulation (so-called co-regulation).

Now we need to explore the literature on possibilities of regulation and self-regulation of ethical behavior in a market. The main research questions of this literature review are to understand if participants of the market can realize the benefits of self-regulation, then reach to an agreement about realistic organizational mechanism and implement this self-regulation in the market.

The very term "self-regulation" has, at a minimum, a sociological, economic and legal content. From the point of view of sociology, self-regulation is an element of civil society capable of balancing effectively system of social processes, actively developing only in conditions state support of the mechanisms of civil society (Bodyakin 2008). From the point of view of economic science, self-regulation is collective regulation of markets and spheres by economic agents, without state interference, and in the legal science its content is also determined uniformly and depends on the industry of legal regulation.

Self-regulation is a set of institutions in which standards and rules of conduct are set by an industry-level organization, rather than at the governmental or firm level (Gunningham and Rees, 1997), The goal of these institutions is to progress mechanisms that form or oblige organizational behavior in order to provide a signal of organizational quality to key stakeholders (Darnall and Carmin, 2005). Self-regulatory regimes might be both private without any state authority and public-private delegated authority to non-state actors. Therefore, self-regulatory regimes can operate either as a substitute for or a complement to government regulation.

Williams (2004) in his paper discusses the potential of industry self-regulation and concluded that it might be a panacea. On one hand, as noted the author, self-regulatory regimes offer some important advantages over more traditional regulation models that could be harnessed to create a more responsive regulatory system. On the other hand, there are several examples of failed attempts at self-regulation and certainly some inherent weaknesses in a great many others that have succeeded. Based on Williams paper, we can state that the emergence of self-regulatory systems is a rational, self-interested response to external pressures in marketplace and the broader societies in which firms operate. And free-riding problem is still a big issue in the industries that go through the path of self-regulation.

To explore concept of industry self-regulation we will stick to William's paper on the economic theory of self-regulation. The author uses some standard economic theories and models

to explain the concept of self-regulation. One model that is very relevant to self-regulation of microfinance industry and can help us to grasp this concept, is principal-agent problem framework.

In his paper, Williams states that when a group of firms decide to establish a self-regulatory regime they enter into an intrinsic contract. And each participant is committed to observe and follow the rules of the association. The main problem with this kind of contact is the fact that the principal (in this case, the self-regulatory association) may not possess perfect information about agents (the industry participants) voluntarily joining the self-regulatory regime, which give rise to the problem of adverse selection (Williams 2004, page 18).

Definitely, some of the firms joining the association to secure the insurance and signing about benefits of membership, but lack actual intention of following through with the commitments. After an agent has joined, the principal might lack perfect information whether the agent is following its contractual duties or not. This situation might bring to moral hazards. In addition, there might be occasions for firms that they will feel pressure to avoid, therefore will choose not to report about it to the principal. Williams believes that all these information asymmetries and conflicts of interest become highly important in determining the success of a self-regulatory regime.

Hence, the importance of institutional remedies rises to cope with these issues of non-compliances in principal-agent relationship in order to have effective self-regulation. As Elinor Ostrom argues “all efforts to organize collective action ... by a set of principals who wish to gain collective benefits, must address a common set of problems. These have to do with coping with free-riding, solving commitment problems, arranging for the supply of new institutions, and monitoring individual compliance with rules. (Ostrom 1990, page 27).

Therefore, any successful self-regulatory system, Williams concludes, probably requires an institutional setting to augment group interaction directed to keeping and strengthening of trustworthy commitments in the following ways:

- through regular meetings of industry participants to share with best practices,
- hiring an independent auditor that can collect, analyze, and distribute information,
- establishing an appropriate and enforceable set of sanctions to punish free-riders and idlers when necessary.

Possibly the most problematic of these three elements are the sanctions, since self-regulation is taken place in voluntary basis, and any pure form rules out legal recourse and external enforcement.

The economic theory of self-regulation in Williams’ paper was merely a starting point back in 2004, and for a much deeper research, pros and cons of industry self-regulation should be evaluated to be able to make more precise judgements. Additionally, more thorough understanding

of the institutional provisions is needed that support cooperation and compliance with rules will lead for the adoption of self-organizing systems in various industries.

Regarding the effectiveness of self-regulation of non-governmental organizations (hereinafter NGOs), an excellent paper came to existence in 2008 by Gugerty M.K. The author, using cross-national data on 20 African countries, shows that there are three major types of self-regulation: national-level guilds, NGO-led clubs and voluntary codes of conduct. The research reveals that voluntary codes are the most common form of self-regulation but have the weakest regulatory strength. In her article, Gugerty uses concept of collective action to show the role that incentives and institutional design might play in overcoming free-riding and shirking problems. The main finding of this article is that there are two conditions for effective self-regulation of non-governmental organizations: clear standards and enforcement mechanisms.

It seems that the choice of a method for regulating some particular activities (in some cases, particular types of legal entities) is carried out by the legislator taking into account the significance of public relations, the risks inherent in the regulated activity, and other factors that may influence the choice of the method of implementation regulatory impact on a particular type of activity.

1.4. Regulation and Self-Regulation in microfinance industry

In this section, first we will review the two main types of MFIs' regulation widely accepted both in theory and practice, then we will review the literature regarding self-regulation of microfinance segment.

Regarding the first task, we will stick to the conceptual guidelines of MFIs regulation and supervision offered by CGAP. The latter is an independent policy and research center that is supported by over 30 development agencies and private foundations. Since CGAP develops and promotes standards to governments, microfinance providers, donors and investors, we will take CGAP's guidelines as a basis for our review of current issues and aspects of microfinance regulation.

For the second task we will review the existing literature related to self-regulation of MFIs. Focus will be held the more recent studies that directly and/or indirectly shed light on the topic of self-regulation in microfinance segment.

Regulation of microfinance institutions

The financial sector is among the most regulated and supervised aspect of economy worldwide, regardless countries' economic development or the nature of political system (Rosengard 2009). This is not accidental or coincidental, since services offered by financial institutions are unique and therefore carry also specific risks. In addition, microfinance institutions are under extra attention due the risks of their operations.

Rosengard states that risks associated with these financial functions are twofold: macroeconomic market failures and microeconomic institutional collapses. According to him there are four macroeconomic market failures related to microfinance institutions: 1) microfinance services are quasi-public goods, necessary for efficient economy that should be available, 2) negative externalities, the difficulties of any single MFI has social impact for the society, 3) macroeconomic disequilibrium caused by the negative externalities, and 4) asymmetries of information, both from savers side that have lack of information to evaluate stability of depositary MFI, and from lenders side who have difficulties to assess the borrowers' willingness to return the loans.

Hence, all these vulnerabilities dictate the need for regulation of the industry in many countries. However, while the importance of the regulation in microfinance admitted by majority scholars, researchers and governmental representatives as well, the distinct types of such regulation is a very tough topic of discussion among the same people.

In 2010, the generalized experience in regulating microfinance activities was reflected in the document of the Basel Committee on "Microfinance activities and the Core Principles for Effective Banking Supervision", which contains 25 principles regulation of microfinance organizations (hereinafter - Basic principles). Some of these principles have development in 2016 in the document " Guidance on the application of the Core Principles for Effective Banking Supervision to the regulation and supervision of institutions relevant to financial inclusion".

Basically, there are two main types of financial regulation in international practice: **Prudential and Non-prudential.**

From one hand, prudential regulation guarantees the financial sustainability of the industry by providing proper legal basis for financial operations to avoid and decrease instability of the sector. A financial authority directly states requirements for MFIs and carries the responsibility of regulated institutions and market.

From the other hand, non-prudential regulation covers regulations about the institution's business activities and processes. A state does not impose financial institutions to follow distinct rules and requirements rather provides with guidelines and standards. These standards are mostly

related to the such topics as consumer protection, financial crimes exceptions, customer-oriented interest rate policies, fraud prevention, information discloser for clients, etc.

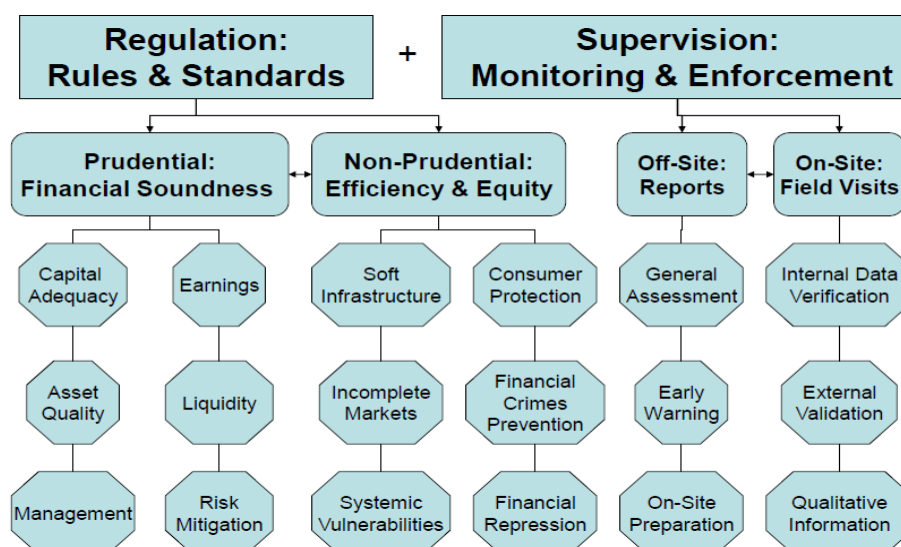


Figure 1: Oversight of microfinance institutions⁶

Prudential regulation of MFIs - according to CGAP microfinance consensus guidelines, following set of prudential regulations are more relevant for microfinance institutions:⁷

Minimum capital requirement (MCR). Generally, the setting of minimum capital that a deposit taker institution should provide to get license for microfinancing activities, is the first standard imposed by authorities. This barrier controls the flow of new players to the market. When, for example, MCR is too high, many MFIs can't enter to the segment. If MCR is low, on the other hand, the market becomes more attractive and almost all MFIs that takes deposits from public could be eligible to enter the market.

Capital adequacy requirement. This ratio refers to the minimum amount of capital a financial institution should hold to avoid solvency problems. According to the Basel 2 prudential standards, all licensed credit institutions are obliged to maintain their level of own funds to minimum 8 percent of their total risk weighted assets.⁸

Liquidity and Foreign Exchange Risks. These are two other areas where the need of more conservative prudential regulation for MFIs that take deposits, is high of course depending on the degree of exposure of MFIs to domestic and foreign markets (Pouchus A, 2012). The depository MFIs should be subject of more stricter liquidity requirements than conventional banks should.

⁶ Source from Rosengard 2009

⁷ Key ideas in this section are drawn from CGAP (2003, 2012)

⁸ Finding Basel 1 requirements obsolete and following some years of discussion and negotiation, member countries adopted the so-called 'Basel 2' approach in 2004, which is being implemented at different speeds in different countries: Europe requires all credit institutions (banks) to adhere from 2008; while other countries follow at their own pace.

Loan Documentation and Reporting. While the requirements for standard banks on loan documentations are mostly justified due to the size and nature of loans issued, from the other side, for MFIs the same requirements are almost irrational considering size of the loans and customers they have.

Protection of Depositors. Many experts and non-professionals contend that if deposits in commercial banks are insured, deposits in other institutions such as MFIs should also be insured. However, countries and regulators should find balanced solutions not allowing deposit protection systems to damage microfinance institutions.

Ownership requirements. Ordinary banking regulations impose clear requirements on who is permissible to become shareholder, minimum number of shareholders and maximum share of ownership for any shareholder. The rationale behind this requirement is to thwart an accumulation of ownership allowing single owner to have a right making key policy decisions in his/her own interest without having consent of others (Eshborne 2003).

Non-prudential regulation of MFIs - includes wide range of issues, that mostly relate to the way of “conducting business” (CGAP 2003).⁹ The following issues are more relevant to microfinance institutions in different countries:

Permission of lending. While in some countries any activity that is not prohibited is supposed to be allowable, and unlicensed entities have a right to lend as long as it is not prohibited legally, for the other countries, especially in formerly-socialist countries, a lending activity of an institution is not clear unless there is a legal regulation to conduct such a business. In third countries, however, only licensed and prudentially regulated institutions are permitted lending activities, regardless these entities take deposit or not.

In both cases, when the legal frameworks are vague or completely prohibited for unlicensed entities, non-prudential regulation is of high importance.

Consumer protection. There are several major customer-protection problems in microfinance concerning almost all countries: (1) abusive lending and collection practices, (2) truth in lending, (3) Over-indebtedness and (4) Interest rate caps.

The first concern is about the protection of the customers from MFIs who loan money without complete and thorough analysis on borrowers’ repayment ability. In many countries, customers are subject for this kind of practices, and states should implement some regulation, usually non-prudential supervision. Also, as many micro-lenders believe that microlending is

⁹ CGAP uses such a comparison of non-prudential regulation and “conduct of business” in Microfinance Guidelines 2003

sustainable only with high repayment rates, however, this kind of approach might lead to tough collection practices having disastrous effect on borrowers and well-being of their families. Here, rules as coercion and pressure exclusion from MFIs practices are subject for state regulation.

The second issue is about providing by MFIs transparent, accurate and complete information about terms and full cost of credits to clients. As already mentioned, fixed costs for MFIs to have the same amount of loan portfolio is much higher than having portfolio of few big loans. Due to this reason, MFIs usually charge high interest rate for their services. In addition, various combinations of transaction fees and numerous interest-calculation methods create real difficulties for the clients to make comparison of interest rates offered by lenders.

For this purpose, many countries impose special requirement on MFIs to disclose their effective interest rates using the same formula stated by regulators. Even though some microlenders argue against such a requirement, however, disclosure of full cost of loans to people is considered to be the major step toward ethical business and also can push microlenders to focus more on increasing their efficiency and reduce interest rates of offered microloans.

After crisis of 2008-2009, the over-indebtedness became more relevant issue for regulatory bodies of many countries. Due to the absence of clear well-established credit reporting systems, the over-indebtedness of borrowers difficult to estimate and make appropriate evaluation and comparisons. Very often, people's inability to repay taken loans is not immediately shown in lender's repayment statistics, which means that under inadequate control, loan officers of MFIs could roll over unpayable loans. In addition, clients might pay the taken loans with new ones. Surely, only taking account all these issues, the balanced and proper regulation should be implemented.

From consumer protection perspective, the set of interest rate caps is another issue for regulation. There is a common argument against regulatory caps that they could damage micro-borrowers' access to microfinance market. This is because of microlenders usually face high administrative costs. Moreover, micro-lend portfolios of MFIs are mostly homogenous and as a rule consist of numerous tiny loans. However, many people do not grasp the idea, that high interest rates mostly are mostly consequence of many objective reasons such as cost structure, structure of capital suppliers.

Credit histories of borrowers. Credit reference services are another subject for non-prudential regulation. Having credit bureaus might be helpful for both borrowers and lenders. The latter, collecting information on client's credit records, can reduce risk of non-repayment and be more courageous in lending, while borrowers could benefit from the opportunity to get loans from different lenders.

Self-regulation of microfinance institutions

Unfortunately, when it comes to the effectiveness of self-regulation in microfinance, the literature is very scarce. Only very few research papers tried to shed light on the issue of effective self-regulation of MFIs.

One such paper that tries to answer whether regulated microfinance institutions achieve better sustainability and outreach, is by Hartarska and Nadolnyak from 2007. In their article, the authors explore the impact of regulation on MFI performance using data for 114 MFIs from 62 countries with the help of empirical model. The analysis shows that regulatory involvement does not directly influence performance either in terms of operational self-sustainability or outreach. The article also finds that less leveraged MFIs have better sustainability, and that MFIs' transformation into regulated financial institutions might not lead to improved financial results and outreach.

Regarding to more recent studies, we have the paper of Dayson and Vik from 2013, which tries to evaluate the effectiveness of self-regulation in microfinance from Europe perspective. The paper analyses over 70 frameworks (guidelines, ratings and codes of practice). Dayson and Vik argue that there are three main factors determining the effectiveness of a self-regulation framework: (1) the absence of an effective mechanism to cope with non-compliance will make a framework weak in setting standards and lacking in credibility, as there are no penalties for those providers not obeying the standards; (2) if a framework includes standards not representing the interest of the whole segment, these standards must be extracted. This is because there is a risk that a code might become current practices for all providers not being determined by the interests of the sector as a whole; (3) absence of transparent, identical and publicly available performance measures which will allow providers make comparisons via peer learning and research on drivers of performance (Dayson and Vik, page 3).

However, the authors conclude that only having framework of all these features does not guarantee the existence of excellent standards and practices of providers. A code of practice is useful if regulation of MFIs is inappropriate for some reasons (e.g. prudential regulation may not be appropriate for MFIs not taking deposits, or it is too extensive for small MFIs), if the need for regulation is modest, if there is limited political appetite to formally regulate MFIs and finally if MFIs are not effectively self-regulated.

Perhaps, the most recent research paper on self-regulation of MFIs is the series of two papers by Afonso, Morvant-Roux, Forcella and Guérin (2016, 2017). Both papers are directed to the investigation of insufficiencies of self-regulation in preventing over-indebtedness using the case of Dominican Republic based on a fieldwork conducted between 2012 and 2015. The authors

conclude that self-regulation mechanisms fail to fully fulfil their goals in the Dominican market. They argue that although financial exclusion justifies the idea of an unlimited microcredit market, however the focus on growth requirements and high competition strongly jeopardize the positive outcomes of microcredit on clients' well-being. They state that the two conditions for effective self-regulation (clear standards and enforcement mechanisms) mentioned by Gugerty (2008) are not met in Dominican Republic.

Therefore, we may expect that an effective combination of regulation and self-regulation of the industry should be directed to the following actions.

- increasing the level of price competition and reducing market power of individual MFIs to achieve a lower interest rate,
- avoiding the practices of providing credits to people who objectively cannot serve the debt (to exclude the lock-in effect in debt funnel),
- avoiding the practices of providing credits to people who subjectively cannot make responsible decisions (have weak will or limited rationality),
- adherence to the principles of more responsible lending by MFIs (usage of more effective evaluation mechanisms to check creditworthiness of a potential borrower),
- setting limits for overall indebtedness of a borrower,
- assistance to increase financial literacy of the population.

Research gap

A review of the current literature regarding ethics, microfinance and regulation reveals that very few authors analyzed the ethical dimension of microfinance, and even few studied regulation and morality-based self-regulation of microfinance organizations.

Both foreign and Russian literature on the topic of self-regulation in microfinance market is very limited, and we can state that research done only scarcely relate to the problem of effective self-regulation.

Number of scholars were trying to illustrate MFOs' role in economy, the issues related to MFOs' activities, challenges of regulation and supervision of the industry. There are also authors writing on various topics related to MFIs, but most of these works carry descriptive character and do not give insights to major ethical problems of the industry that generate the necessity of state regulation.

Therefore, there is a gap regarding research in the field of effective approaches to self-regulation of microfinance industry, as well as studies analyzing how SROs could effectively prevent MFOs from unethical and unscrupulous practices.

Chapter 2. Regulation of microfinance institutions in other countries: historical overview

In this chapter we will review of international experience of regulation and self-regulation in different countries to see if our theoretical framework works and what is the practical solutions. In section 2.1 we will discuss briefly the main models of microfinance organizations' development accepted by majority scholars. In section 2.2 we will discuss the experience of United States in microfinance industry regulation. In section 2.3 we will first describe the history of microfinancing in Europe and then discuss several countries' experience of MFIs regulation (France, Germany, United Kingdom, Poland, Hungary). In section 2.4 we will describe the experience of Southeast Asia and countries which comprise a very different picture of microfinancing (Bangladesh and India).

Before turning to the review of MFIs regulation and self-regulation experience in other countries, it would be better to set several questions that will navigate us through this journey. Thus, in this chapter we should try to find answers to such question as: (1) which of the issues discussed in the first chapter are really regulated in various countries? (2) what are the combination of regulation and self-regulation in various countries and what factors determine it? (3) when and how self-regulation failed or succeeded in different countries? (4) whether can we say that state regulation is always effective or ineffective?

2.1. Main models of microfinance institutions' development

Generally, there are three major models of modern microfinance institutions' development in the World practice that are widely used among majority scholars: American, German and Mixed. As a basis for such division is considered the motivation and the functionality character of financial institutions.

1. American model is oriented mostly to the development of small business, which is implemented directly by the State. In particular, this function is the duty of US Small Business Administration (SBA) - an independent federal government agency, established under the Small Business Act in 1953. The agency was created for the lobby of his interests at the state level and has a substantial number of branches across the country.

2. The German model, having the same functionality of supporting small entrepreneurs, is based on the interaction of the state bank with private financial institutions. At the same time, the functions of the distributor of federal money are on the KfW Development

Bank. However, the microfinance activities are carried out at the expense of private financial organizations, which lend to entrepreneurs.

3. The representatives of Mixed model are such underdeveloped countries as Bangladesh, Brazil, etc. In this case, the motivation behind microfinancing is mostly directed to the decrease of poverty. This model is also considered to be the classical model of microfinancing, as it comes from Grameen Bank's experience.

2.2. Regulation of microfinance institutions in United States

The roots of microfinance in United States go back to the late 19th century, when so called "salary lenders" emerged.¹⁰ It was a period, when low interest rates for loans were hampered legally, and microlending was not profitable. In this situation, in place of legal lenders, illegal small lenders started to offer loans to people openly, considering that their actions are legitimate. The main problem of this kind of illegal lending was the absence of legal basis for lenders that they could use to enforce repayments of loans by borrowers. This circumstance made these lenders to adopt other alternative ways of to ensure the repayment of given loans such as using the bad image of defaulters among majority employers. The latter prefer to fire and not hire people who were under debts. This technique was effectively used by money lenders also called "loan sharks".

Small loans offered by these lenders were given with high interest rates justifying it with the high costs of tracking and pursuing potential defaulters. The attitude of lenders toward defaulters were also varying. While some lenders were more benevolent and tried to offer options helping borrowers to get out of debt funnel, the others demonstrated unscrupulous practices of collection.

The role of borrowers' supporters took social elites such as businessmen and charity organizations, who provided borrowers the opportunity to protect their rights. With the help of these charity associations, later the draft of Uniform Small Loan Law was ratified, which was continued to other states beginning from 1917. After this law was enacted, consumer protection mandated and interest rate caps were set in size of 3.5% a day (42% a year).¹¹

The next period of illegal microlending started in 1920s, when so called violent loan sharks came to existence which were also accused for their ties with mafia and criminal. These new types of lenders claimed that they were not engaged in microlending activities rather buying rights of

¹⁰ Resource available at https://en.wikipedia.org/wiki/Loan_shark

¹¹ Ibid

salaries. Although decreasing steadily, American loansharking continues to exist even today, when legal payday lending is surging in all states.

The new era of microfinance in United States started from 1970s, when necessity of inclusive financial system for people, who stayed aside from financial products and services, became broadly obvious in the country.

The development of microfinance market was accompanied with the recognition, establishment and development of small business. As the importance of small business was growing dramatically Small Business Administration (hereinafter SBA), a federal government agency was tasked to clarify and define the small business and its owners in formal way (Pierce, 2013). For this purpose, SBA in 1991 created new type of business calling it microenterprises, entities, that have five or fewer employees including owners.

With the growth of small business, the importance of microfinance also grew in the country. In 1973, StoreBank Corporation was founded in Chicago's south side where small enterprises were lacking financial resources (Timeline 1973-2011). Also, Woman's Economic Development in Bozeman, Montana was formed to help female entrepreneurs to get access to financial system. Basically, these two organizations highlighted the importance of small businesses who are in vulnerable zone and do deserve benevolent conditions for financial inclusion.

Since 1977, several laws and legislative acts came to existence to support access of microenterprises to microfinance market. The major one was the "Community Reinvestment Act" of 1977 (CRA), with which Congress requires financial institutions to implement their duty of serving the community with credits and deposits. Likewise, CRA encouraged banks to invest in MFIs offering low-income population safe and transparent services. Going forward with this course, CRA empowers regulators to base ranking system of banks on their participation in such activities. However, this act was criticized later for its lacking directives for encouragement and basis for determination of appropriate institutions to meet community's credit needs (Leminh 2015).

Self-Help Credit Union was created in North Carolina as a model for microfinance institutions for *Community Development Financial Institutions* (CDFIs) in 1980 (Leminh 2015). These institutions served the low-income individuals with broad microfinance products. Later Self-Help grew to national level. In 1990s the industry rush and several regulations came to existence. In 1991 ACCION International¹² bring its model of microlending to USA (Timeline

¹² ACCION is a community development organization that was founded in 1961 with the aim of enabling people living in poverty to assist themselves through their own skills and talents.

1973-2011). The organization piloted the first microlending program in Brooklyn, New York, that targeted small-scale, informal economy entrepreneurs. Starting from New York City, the ACCION U.S. network very soon became the biggest microlending network in the country already in 2006 with its five members.¹³

So far microfinancing in the United States stopped to be just small activities with insignificant amounts, but rather well-developed industry. In 2010, almost 347,000 people benefited from Pay Day Loans totaling \$164 million.¹⁴ The same year took place the first Microfinance USA nationwide conference gathering practitioners, policymakers, investors and enthusiasts to engage, explore, and expand the domestic microfinance field (Timeline US).

Presently, the main MFIs in the United States implement microfinance activities in one of three forms: (1) non-profit organizations that act as distributors of federal money, (2) non-profit organizations that operate independently from the government, and (3) for-profit organizations (Pierce). The role of SBA is to distribute federal money to non-profit lenders, not to directly lend small businesses. Basically, SBA provides MFIs with guidelines for loans, and MFIs as third-party are distributing government's money through various SBA programs.

The biggest MFI in United States is ACCION USA, which distributes most of SBA funds. Up to now ACCION issued loans worth 305 million since its founding. The average loan from ACCION is \$7000 with interest rates ranging 8,99% to 15,99%.¹⁵

Customer protection related regulation. Basically, the formal statutory regime, overriding banks and other for-profit lenders, does not have effective frameworks for microfinance activities. This problem comes from the fact, that there is not clear categorizing of MFIs. And after the recent financial crisis, United States was forced to reevaluate its regulatory environment for microfinance activities. As a response to the financial crisis, The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (DFWSRCP) was signed by president Obama on July 2010.¹⁶ This act reconsidered the past few decades' trend of deregulation and stressed the necessity of at least some safety measures and precautions for microcredit regulation (Leminh 2015).

Interest rates and abuses related regulation. Although less controversial than ones of customer protection, however microfinance in United States includes issues of high interest rates

¹³ The five members are ACCION Chicago, ACCION New Mexico-Arizona-Colorado, ACCION San-Diego, ACCION Texas-Louisiana and ACCION USA

¹⁴ 2011 US Microenterprise Census Fast Facts, FIELD AT THE ASPEN INST. (Feb. 2012), resource available at <http://fieldus.org/publications/2011CensusFacts.pdf>

¹⁵ Figures are from 2013, need to be updated

¹⁶ [https://en.wikipedia.org/wiki/Dodd%E2%80%93Frank_Wall_Street_Reform_and_Consumer_Protection_Ac](https://en.wikipedia.org/wiki/Dodd%E2%80%93Frank_Wall_Street_Reform_and_Consumer_Protection_Act)

related to the payday lending regulation. As noted Leminh (2015) wage assignments were used to secure payday loans in the 1900s, which enabled the lender to collect payment from the borrower's employer. Currently, a typical situation in a payday loan is demonstrated in other ways: the consumer writes a \$300 check payable in few weeks and receives back \$255 in cash at the time he or she needs it. The remaining \$45 the lender keeps as commission for its service. Lenders simply collected payments from the employers of borrowers. As already mentioned above, in 1916 Uniform Small Loan Law (USLL) was drafted as a result of efforts by regulators, customer advocates and lenders (Leminh 2015). The law was issued to enable small-loan lending at “the lowest practicably profitable rates by licensed and transparent lenders” (Mann R.J., 2012). By 1950s the USLL was adopted in ¾ of states. Regardless, at state level usury laws set interest rate caps, payday lenders found loopholes in the laws and developed maneuvers to keep high interest rates.¹⁷ And only in 2005, the Federal Deposit Insurance Act (FDIC) disseminated regulations dealing with these affiliations of the law and set increased capital requirement and supplemented more inspection for Banks and other micro payday lenders.¹⁸

In addition, the Federal Trade Commission Act (FTC Act) and the Consumer Credit Protection Act (CCPA) were issued in 1914 and 1968 correspondingly to address loan collection practices of microlenders. According to FTC act, its own created commission of Federal trade got an authority collect information on peoples’ complaints about unfair lending practices. From the other hand, CCPA’s key provision requires calculations of all direct and indirect financial charges that lenders get as an overall amount from a borrower.

Transparency related regulation. Another issue needed regulation not only in United States but also in other developed and developing countries, is the ambiguous and not transparent contract information micro-borrowers get from lenders. As the methods of interest rate calculations are usually complex, customers’ understanding of loan contracts are very low as well.

For transparency issues in microlending processes, the *Truth in Lending Act* (TILA) was designed in 1968 in United States to promote the informed use of consumer credit.¹⁹ The TILA, being a part of CCPA, was supposed to bring stabilization and competitions among various lenders. The act requires *Annual Percentage Rate* (APR) calculation for consumer loans as well as for mortgage loan transactions. Authorities (The House Committee on Banking and Currency) issuing the act reported that American consumers will get all the necessary information to compare

¹⁷ As an example, lenders argued that their loans are not falling under the definition of the usury laws, and that borrowers are incurred fees rather than interest.

¹⁸ https://en.wikipedia.org/wiki/Federal_Deposit_Insurance_Reform_Act

¹⁹ https://en.wikipedia.org/wiki/Truth_in_Lending_Act

the cost of credit and make well-informed decisions. The most specific requirements of TILA are included in Regulation Z promulgated by Federal Reserve Board. In turn, Regulation Z defines a “finance charge” as amount that is equal to the cost of credit for customer. Finance charge itself consists of interest, premiums, fees, and various other charges.

After TILA came to existence, for more than a decade APR calculation were reported by lenders until 1980s, when auto producers found loophole in TILA and its administration. Basically, they found that the act and its administrators do not distinguish between terms “amount financed” and “finance charges”.²⁰ Auto manufacturers took advantage from these gap, and by bundling the price of the car with other charges, essentially were even able to eliminate financing charge completely. Thereafter, the “zero percent APR was born.”²¹

Therefore, we can say that although the field of microlending is largely unregulated in United States, however, different legislative and usury acts concerning banking activities, for-profit and non-profit organizations’ regulation, indirectly control microfinance activities in the country. Acts like Community Reinvestment, Equal Credit Opportunity, Program for Investment in Microentrepreneurs, The Dodd-Frank act, Consumer Credit Protection and other acts as well accompanied with different laws that set interest rate capping and capital adequacy requirements for non-banks institutions, constitute the overall regulatory framework of microfinance institutions.

2.3. Regulation of microfinance institutions in European Union

In this section, we will study the experience of microfinance regulation of such European countries as Germany, France, United Kingdom as well as Poland and Hungary as transiting countries. We will also describe briefly the policy of European Union toward microfinance regulation.

²⁰ <https://www.investopedia.com/terms/t/tila.asp>

²¹ Indeed, buyers of automobiles have a choice to offer customers \$1,000 (typical offer) rebate to get rid of interest, and as manufacturers can bundle the offer, credit unions, banks and other microlenders are left at a disadvantage.

Microfinance in Europe: overview

In Europe microfinance originated from 16th century, when it became as an intermediation between micro-savings and micro-credits, having the goal of increasing poverty alleviation. Ireland and Germany are countries that have developed prototypes of current European microfinance.

The history of Ireland microfinance dated back to 1720-1950, the period when financial innovation and conducive regulation pushed microfinance to grow at the beginning, and adversative regulation brought it down at the end (Seibel, 2005).

The first Irish loan funds came to existence at 1720 as charities financed by donors. The loans offered by these funds were free of interest at the beginning, but very soon they transformed to intermediaries offering short term loans with peer guarantees. Even though there was moderate growth during the next century, however the funds flourished when two events took place. First, the law authorizing the funds to collect interest-bearing deposits and charging interest on loans issued in 1823, and second, Loan Fund Board was established as a regulatory and supervisory body in 1836. After these changes, the number of funds increased to 300 by 1840.

As the deposit rates offered by funds were high than that's of banks, the interest rates charged by funds were also higher. So far getting sources of self-financing from deposits and profits, the Irish funds took almost 20% market share from traditional banks. The latter threatened by increased competition from micro-lenders, Irish banks managed to lobby a law putting a cap on interest rates (Seibel). After, losing their advantages due to incomes from high interest rates, the Irish micro-lending funds slowly declined and completely disappeared in 1950s.

The story of German microfinance is a good example of regulated microfinance sector created by self-help, self-regulated, and delegated supervision that started from the second half of 18th century. It consists of two networks: community-owned savings funds called "Sparkassen", and member-owned cooperatives. The first saving fund was in Hamburg in 1801 (Guichandut et. Al 2007). As Germans already learned from Irish experience that charity is not sustainable, and also the fact that demand for micro-savings was growing for poor people, all these factors pushed Saving funds change their business and offer credits. After, the Prussian state set up a regulation on this activity by passing Prussian Savings Banks Decree in 1838. As a respond, German savings funds association formed later in 1884.

The second wave of German microfinance started after the hunger year of 1846/47. During these two years, the starvation was widespread and poor harvest made many farmers and small businesses go bankrupt. Only two courageous men took action after those days. In rural regions, Raiffeisen opened credit associations later known as Raiffeisenkassen, and in urban areas

Schultze-Delitzsch established small business savings and credit cooperatives later called Volksbanken.

Raiffeisen opened the first rural credit association in 1864. The number of such associations slowly grew to 245 in 1880s. But when The Cooperative Act of German Reich was passed, the number of associations increased sharply reaching to 15,000 and spreading to other countries as well. According to the Act, the joint liability of association was changed by limited liability, which allowed cooperatives to grow rapidly till the overall banking law was issued in 1934. All financial institutions were subject of regulation under the banking law and became universal banks of today. Both chains grew to enormous sizes and at the end of 20th century comprised 39,000 branches, 75 million customers, 64% of all financial intermediation and 51.4% of all banking assets (Seibel).

Generally, EC defines “microcredit” as:

- a business microloan is a loan under EUR 25,000 to support the development of self-employment and microenterprises;
- a personal microloan is a loan under EUR 25,000 for covering clients’ personal consumption necessities such as rent, personal emergencies, education.

Although some factors such as a proper legal framework, effective delegated supervision, and institutional self-reliance without government interference have been crucial for the development of microfinance in European continent, however various European countries have taken different paths in microfinance.

Surely, the experience of German and Irish microfinance will not illustrate how separate countries developed their own models of microfinance, and for more concrete judgement we should briefly analyze at least how microfinance developed in some European countries and what type of regulation have these countries on microfinance activities.

Table 1: Microfinance Regulation and interest rate caps in USA and some EU countries²²

Country	Microfinance Regulation	Interest Rate Caps
United States	Small Business Jobs Act of 2010	No
France	Monetary and Financial Code Art R518-61	No
Germany	No Specific Regulation	No
United Kingdom	No Specific Regulation	No
Poland	No Specific Regulation	Yes
Hungary	No Specific Regulation	Yes

²² Source by author

France

The first microcredit organization in France was ADIE established in 1989.²³ It was a time of very strict banking laws that prohibited any kind of non-bank borrowers from refinancing. For this reason, ADIE was loaning only from own funds, which limited the capability of the company to increase its portfolio. After Adie has carried out significant lobbying, some changes took place regarding the Banking laws. First, in 2001 some improvements in the law allowed microcredit associations to receive funding from banks. Then, in 2005 the Social Cohesion Fund (FCS) was formed to guarantee microcredit loans. According to official data published by Banque de France, in 2011 the FCS secured over 200m Euro in loans from banks. These guarantees offered by FCS made possible rapid expansion of microcredit market in France.

In 2009, the state created the New Support for the Creation and companies' buyout (the NACRE operation) that allows the development of interest-free loans by banks. Next year in 2010 "The consumer law" was issued that directs consumer credit and specifies the legal framework for microfinance. This law permits associations to obtain interest-free loans from individuals. Moreover, in France microfinance associations currently can finance themselves through various crowdfunding platforms such as Babylon or Xetic (Bendig el., 2014).

Generally, the microfinance sector in France distinguishes between two types: (1) Personal microcredit or Consumption loans to finance social and professional integration projects. (2) Professional microcredit or Professional loans to support of small businesses letting entrepreneurs to create their own jobs. Usually, the biggest part of total loans (over 80%) are professional microloans, while the remaining 20% goes to personal microloans.

The other main actors of the market are France Active and France Initiative that are investing in various segments of the population. For example, Adie is active for unemployed and citizens with social minima, while France active is more inclined to loan unemployed and social entrepreneurs.

Currently, the regulation of microfinance entities is based on two key legislations. The first one is Monetary and Financial Code from 15 May 2001 with its article L.511-6-5 and articles from L.518-57 to L.518-64, and the second is the Law from 18 January 2005.

According to the article L.511-6-5 of the Monetary and Financial Code, non-profit associations are allowed to endow credits to unemployed people living on social benefits or for ones that want to create or develop their own new business. The loans are offered by associations which are borrowed by banks and/or from owners as an equity. In turn, the associations need to be

²³ <https://www.adie.org/microfinance-in-france>

permitted by special committees to implement micro-crediting activities according to certain criteria. The all conditions and requirements to get permission are described in the articles L.518-57 to L.518-64 of the Monetary and Financial Code. The main requirement is that loans are offered with interest not exceeding 6000 Euro and meet all the conditions of Banking Law which equally regulate both NGOs and commercial banks.

The second is “The 18 January Law 2005”, which created the Social Cohesion Fund. As already mentioned The SCF provides financing to guarantee societies which provide guarantees to microcredit associations (EC, Expert Group Report, 2007).

Germany

Regardless the banking sector in Germany is quite efficient, young and small enterprises very often face special problems when seeking capital providers for their projects. Since cost/earnings ratio is usually low, microlending is often unprofitable for banks in Germany in the “conventional” way of doing lending business (Guichandut et al., 2007).

The amounts of loans to entrepreneurs that are in the initial stage of their business are usually too small to cover the high risks and high operating costs, which are result of difficulties in assessment process of credibility and considerable risk of failure for start-up. Thus, small-scale projects very frequently fail because banks and other intermediaries are not willing to loan these young businesses and business ideas.

In Germany, there are three types of non-bank entities providing microloans to entrepreneurs: (1) Microfinance Institutions, (2) promotional banks, and (3) local employment agencies (Bendig et al. 2014).

Microfinance Institutions, due to their relatively small sizes, cannot get banking status. In Germany, these institutions are operating in local, regional and nationwide levels. Since 2004, in cooperation with banks, MFIs developed more advanced lending practices: cooperative banks distribute the loans, while MFIs serve the clients during the whole period of the loan. In case of default, the risk is divided equally between MFIs and guarantee funds so called “Mikrofinanzfonds Deutschland”. The latter were established based on this cooperation model, and since 2010 these funds increased to 100 million Euro.

In contrast, promotional banks have the status of bank. Some banks have developed specific microloan products with such partners as ESF and ERDF, while others offer microloans below 25,000 Euro. Federal KfW provides clients loans with such conditions as well.

Local employment agencies are responsible for lending those people that are long-term unemployed.

The main law in Germany regulating the activities of commercial banks, cooperative and saving banks, guarantee societies and NGOs is German Banking Act (Kreditwesengesetz KWG). It is a Federal law containing different acts for banks and other financial institutions. The main goal of KWG is to provide legislative basis for a functioning and secure credit service sector from one hand, and to protect the customers against losses from the other hand (EC, Expert Group Report, 2007). According to paragraph 32 of KWG, German Financial Supervisory Authority BAFIN should give a written permission to banks in order that they could conduct microlending.

United Kingdom²⁴

Microfinance institutions in the UK are operating in various legal forms but are predominantly not-for-profit organizations that have social missions to assist local communities. Typically, microfinance approach in the United Kingdom is to help customers with advice, loan finance, mentoring, who stay out of banking financing.

Both state and the banking sector play a significant role in the microfinance industry. From one side, the government assist with greater microfinance lending and private investment into MFIs, while from other side provides MFIs with funding such as grants that MFIs use as a third party to fix specific market failures or public needs.

In its turn, the banking sector also plays a significant role. In the UK Banks and MFIs have a referral partnership, where banks recommend their declined customers to MFIs. Banks are also a source of funding for MFIs.

So far, the main founders of CDFIs became public agencies. Regional Development Agencies (RDAs) and the devolved administrations of Scotland, Wales and Northern Ireland, combined with the nine English regions started to finance and support CDFIs. Banks, social investors, charitable trusts and foundations provide substantial support to CDFIs as well.

In UK loans less than 25,000 Euro are defined as microfinance loans by CDFIs. Interest rates charged by the CDFIs varies from 0 to 26 %, the amount of loans is between 286 and € 9447 (Goggin and Dayson, 2010), and the repayment period of microloans is kept at 18 to 60 months.

The regulatory framework in the United Kingdom has recently changed. From multi-body financial regulatory system, in 2013, UK turned to centralized regulation system. The centralized body became the Financial Conduct Authority (FCA) that regulates all firms providing consumer credit. As a result, the FCA has projected a more demanding regulatory regime, including higher

²⁴ After 2016 June referendum UK should leave the EU in March 2019, source available at <https://en.wikipedia.org/wiki/Brexit>

fees, than the previous regulator. Even though this kind of strict regulations are put extra burden for MFIs, however, the FCA with its new regulatory regimes intends to create a more ethical financial services industry in the UK, which will benefit MFIs as well.

The main legislative acts regulating microfinance activities are Credit Unions Act and the Industrial & Provident Societies Act 1965.

Credit Unions are obliged to register under the Industrial & Provident Societies Act issued in 1965 to get corporate status. Credit Unions Act that was issued in 1979, governs the provisions of activities that credit unions implement. According to Credit Unions Act loans may only be made to natural persons, who share a common tie. However, some of these loans will be used by sole traders for business purposes.

Also, credit unions are regulated by the Financial Services Authority under the Financial Services and Markets Act from 2000 that authorizes unions and specifies which operations they can implement. CDFIs may registered as companies regulated under Company law or as community benefit societies registered under the Industrial & Provident Societies Act issued in 1965.

Poland

In Poland there are three main types of institutions that operate actively in microfinance field: (1) Microcredit organizations that only lend, (2) “Loans funds” which offer nit only loans but other business development services. These funds operate in forms of regional funds or local foundations, (3) Banks that loan mainly Micro, Small, Medium Enterprises (MSMEs).

While Grameen Bank succeeded in Asia, at the same time Fundusz Mikro in Poland became the most successful microfinance organization of Eastern Europe. It was established in 1994 by the Polish-American Business Foundation (PAEF) with the aim of promoting micro business in the country. Now, there are more than 30 branches operating in all regions.

The Fund offers its microloan services with following principles (Guichandut et al. 2007): (1) the loan is issued for a period of 3 months; (2) the average loan size is \$ 1,500; (3) the effective interest rate is 35%; (4) 55% of all borrowers are women. What is important that the level of loan repayment is 98%.

Aside from Fundusz Mikro, two other microcredit funds are operating in Poland, which specialized to help businesses in agriculture: (1) The Polish Agricultural Development Fund (PADF), a private non-profit organization founded in 1998 for development and support of agricultural activities, (2) The second fund is the Agricultural Fund (AF), which was established

by the Ministry of Agriculture and Economy of Poland in 1991 and focuses on start-up projects (the main condition to receive credit is a 40-100-hour training of a business course).

There is no specific regulation and laws in Poland for microfinance activities. A range of institutions such as banks, credit unions, cooperatives, foundations, associations and other NGOs can provide microloans. All these institutions are guided under general regulation such as civil, commercial, and labor codes, banking laws and regulations, as well as, Act of competition and consumer protection, and personal data protection act (Bendig et al. 2014).

The act on competition and consumer protection was issued in 2007 and protects consumer interests in three directions such as transparent contract terms, distribution of inaccurate and false data, and unfair competition practices. Only banks and credit unions are allowed to take deposits and providing of client data to credit bureau is not obligatory for MFIs.

In Poland, from 2005 there is also regulatory cap on interest rates of 16% (four times the central bank Lombard rate of 4%) (Maimbo and Gallegos, 2014), however, due to the loopholes of legislation, microfinance institutions can apply different fees and charges so increasing the full cost of the credit. Recently, companies engaged in PDL segment, have received much criticism about the fair cost of credit. In response, the polish government intends to make changes in the law regarding the supervision of non-bank microfinance institutions, and to set limits on the full cost of credit.

Hungary

In Hungary, the implementation of microfinance programs is carried out by the Hungarian Enterprise Support Fund (HESF), founded in 1990 with the aim of providing financial support to small and medium-sized businesses, which created an extensive branch network consisting of 20 representative offices so called local enterprise agencies (LEA).

Only in the first 4 years of existence, HESF issued approximately 1,000 loans in the amount of \$ 3 million. Due to crises, it became almost impossible for SMEs to get bank loans, the objective of microfinance was changed many times as well. According to the Overview of microcredit sector in EU (2014), the value of microloans granted amounted to 46,7 million Euro.

The next step in the development of the microfinance system in Hungary was the creation of the State Committee on Microcredit, which introduced conceptual changes in the microcredit system. Since 2004, the microcredit management has been transferred to the Hungarian Development Bank, which started from 2005 to implement the "Microcredit Plus" program, in which microcredits are provided to borrowers through local business associations that also carry out their monitoring.

Generally, there are no legal framework regulating microfinance sector in Hungary. However, there are special rules that regulate the operation of micro-lending institutions.

In 1998, the Hungarian Parliament revised Act No. CXII of 1996 on Credit Institutions and Financial Enterprises in a way that it excluded the activities performed by those LEAs that don't comply with the act's requirements. Although there is no legal obligation regarding the creation of lending rules for LEAs, but the regulations developed are in line with requirements of The Act on Credit Institutions. For the regulation of foundation, there is also a Microcredit Manual, which contains the detailed rules of the Microcredit Program (EC, Expert Group Report, 2007).

Going back to microfinance in EU as a union, we should state that microfinance industry in Europe has emerged from both the "Developing world" and the United States, combined with some historical patterns. As we saw, the biggest part of microfinance in European union is provided by funds from the state and to a lesser extent from banks. Also, we saw that each country in Europe has its own exceptional microfinance sector with some similarities and distinctions from others in the region.

Having, however, all these differences, the authorities of the Union tried to standardize and harmonize the practices of interest rates estimation and full information disclosure for European customers with the aim of unified customer protection in all member states. For this purpose, the European Parliament and The Council issued the Directive 98/7/EC on the single method of Annual Percentage Rate estimation in February 1998. The goal of the directive with the standardization of APR was directed to the transparency and consumer rights announcing that every creditor has to use the form when marketing a consumer credit in any member state.

Afterward, the directives 2008/48/EC and 2011/90/EC came to existence on credit agreements for customers, which supplemented the Directive of 98/7/EC. All these directives reinforced the EU regulation toward microlending practices and forced member states to fully obey the directives already started from 2013.

Likewise, European Commission issued the European Code of Good Conduct for Microcredit Provision in 2011. As stated in the provision, the importance of Code of Conduct for the promotion of best in the field of microfinance is very high due to the diversity of lending practices in member countries. As the authors of the code mentions the latter is not for the replacement of existing regulation but rather it is intended to detail a set of common standards in terms of operation and reporting of microlending providers.

The Code targets microcredit provider managers, directors, customers, investors, funders, owners, regulators, and partner organizations. It is not obligatory for implementation but very advisable for all microfinance institutions that are engaged in microlending activities.

The main aspects The Code touches are: sufficient information to customers, customer rights, avoiding over-indebtedness, customer care, ethical staff, customer data protection, investor relations, governance and management of microfinance institutions as well.

According to the news published in microfinance network website, Europe's first microcredit provider (MCP) to receive certification for compliance with the European Code of Good Conduct for Microcredit Provision is the Dutch company Qredits. Qredits was founded as a non-profit organization in 2009 to contribute to the social and financial inclusion of micro-entrepreneurs in the Netherlands.

2.4. Regulation of microfinance institutions in Southeast Asia

In this section, we will study the experience of microfinance development and regulation in two Southeast countries: Bangladesh and India. Both countries do have well-developed and diverse microfinance industry, which will allow us to make proper comparisons with Russian microfinance industry in later chapters.

Bangladesh

It's believed that microfinancing takes its roots in 1976 from Bangladesh. Professor Muhammad Yunus, seeing how his fellows are suffering from high rate loans from envy moneylenders, started himself lending low rates loans to poor people to support their small businesses. The business model became viable, and non-return rate was 3% in comparison to today's 30% average that we have in microfinance market in Russia. Later, Yunus opened his Grameen Bank, which has issued US\$6.38 billion to 7.4 million borrowers by July 2007.²⁵ Only after almost 30 years, in 2006, Yunus was awarded a Noble prize for his contribution to "the economic and social development from bottom". So, Yunus has developed and implemented a new approach to micro lending in Grameen Bank, which includes such elements as group contracting, dynamic lending mode, regular and frequent repayment of the loan received, absence of collateral.

Bangladesh microfinance sector is one of the oldest and most diverse in the world, which includes such largest and sophisticated microfinance institutions as Grameen Bank, BRAC, and ASA.

²⁵ https://en.wikipedia.org/wiki/Muhammad_Yunus#Early_career

Microfinance has been operating in Bangladesh for almost forty years. In 2014, 33,73 million of clients (including Grameen Bank) were being served with various financial and non-financial services by 742 registered microfinance institutions (MFIs) in Bangladesh (MRA, 2015)

Currently, microcredit programs in Bangladesh are implemented by NGOs, Grameen Bank, state-owned commercial banks, private commercial banks, and specialized programs of some ministries of Bangladesh government.²⁶

Initially, the microfinance sector was not regulated in Bangladesh, and there was not a regulatory authority to control and supervise microfinance activities. Before 2006, MFIs were registered under various acts. As the sector succeeded and grew worldwide, the need for regulation has also gradually increased.

After number of meetings, discussions, recommendations from the participation of Bangladesh Bank, Ministry of Finance, social welfare Ministry, and major participants of the sector, The Steering Committee offered its regulatory framework only in 2003, which the government accepted.

In 2006, almost three decades after the initiation of microfinance in Bangladesh by Yunus and Grameen Bank, an independent regulatory authority was established, known as the Microcredit Regulatory Authority (MRA) after The Act 32 was enacted 2006.

The initial goal of the establishment of the MRA was to create a favorable and healthy atmosphere for microfinance practices in the country and to protect the interests of clients of MFIs, but meanwhile not hurting the long-term sustainability of MFIs. For this MRA has issued and provide MFIs with detailed guidelines to increase governance practices. In addition, MRA advocates for prudential policy design, superior competition, productivity and efficiency for long-term sustainability of the sector (MRA, 2015).²⁷

With the enactment of the Microcredit Regulatory Authority Act, all NGO-MFIs were put under the control of MRA. However, other types of MFIs, such as cooperatives, credit unions, non-bank financial institutions, and state-owned or commercial banks engaged in microlending activities are not under the jurisdiction of the MRA. All these institutions are supervised under the corresponding Acts of their particular authorities, from which they have obtained their operating licenses (Mia A. 2017).

Each MFI should receive a license from the MRA to carry out microfinance activities in the country. To guarantee transparency and accountability of microfinance operations and

²⁶ Source available at http://www.mra.gov.bd/images/mra_files/News/mcinbd17082015.pdf

²⁷ Resource available at <http://www.mra.gov.bd>

activities, the authority is implementing the removal of licenses from MFIs that fail to obey requirements set by the MRA.

The MRA has issued different set of rules and requirements regarding MFIs membership, loan conditions, funding and segment sustainability related obligations from very beginning of foundation.

The MRA has enacted a regulation capping microfinance institution (MFI) loan rates at 27 percent per year as of July 2011. In 2009, MRA temporarily fixed interest rates at a 15 percent flat rate or 30 percent effective rate (Khandker et al. 2013).

India

India has an excellent microfinance history predates by two to three millenniums. In ancient India, microfinance existed in the form of intermediation including deposit taking, lending and other financial services known as merchant banking at these days.

In the middle ages, due to the rapid growth of trade between India and Asian countries merchant banking surged as well. The merchants were charging interest rates between 0.5% and 1.25% per month on secured loans and between 40 to 60% per trade venture on risky trade (Seibel, 2005). Other forms of informal finance existed in the form of micro lending by money lenders, traders, merchant bankers, chit fund companies and Rotating Savings and Credit Associations (ROSCAS).²⁸

The oldest type of informal microfinance is the money lenders who existed probably 1700 to 2200 years ago, after which this profession became an organized one and demanded subsequent regulation. Money lenders still exist in both rural and urban India with some of the historical remnants of this profession.

As the business of all these informal microlenders grew, the need for regulation of these activities grew as well. Different legislative acts were passed to regulate activities of informal microlenders already in the second half of the 20th century.

In parallel, the formal sector of microfinance also grew mainly due to the efforts of the Indian government and the Reserve Bank of India. The Indian cooperative movement started after the government of Madras stated its willingness to use German cooperative movement to decrease the poverty in India. This happened after the Britishers promoted credit cooperatives to serve their

²⁸ Resource available at <http://shodhganga.inflibnet.ac.in/>

trade interest and later enacted the Cooperative Credit Societies Act in 1904 and Multi-Unit Cooperative Societies Act in 1942.

So far, the government initiated the microfinance movement through various formal channels and programs making India the country that give birth to many types of microfinance models. As the range of entities in Indian microfinance sector varies from Banks to non-profit lenders, it is always difficult to identify of appropriate regulation for MFIs in general.

There are certain prudential requirements for microfinance loans to acquire priority sector status. The majority of microfinance in India is provided by commercial banks, regional rural banks (RRBs), SHGs (very often with special linkage programs to commercial banks), cooperative societies, and microfinance institutions (MFIs) that take a variety of forms, including NGOs and non-bank financial companies (NBFCs).

According to CGAP, different microfinance entities in India are regulated by various authorities correspondingly: (1) Banks and NBFCs are regulated by the Reserve Bank of India (RBI) with the National Bank for Agriculture; (2) Rural Development (NABARD) is supervising and inspecting RRBs; (3) SHGs are regulated by NABARD; (4) cooperative societies are regulated by the state-appointed Registrar of Cooperative Societies (RCS) and state government (with NABARD conducting supervision and inspections); and (4) and cooperative banks are regulated by RBI and RCS.

RBI resolved its lack of capacity to supervise the microfinance sector by creating a framework for monitored self-regulation. Moreover, since not all MFIs are registered as NBFCs, hundreds of them fall outside of the regulatory scheme. So far Self-Regulatory Organization (SRO) status was granted first to the Microfinance Institutions Network (MFIN), a trade association composed of 47 Indian microlenders that operate as non-banking financial companies, and then to Sa-Dhan, a microfinance network with 251 members.

SROs are required to develop a code of conduct for their members, to guarantee compliance, as well as to establish an effective grievance redressal system for borrowers and a system for resolving disputes between member organizations (Directive of RBI on SRO for NBFC-MFI from November 26, 2013).

Under pressure from RBI, MFIN has created a code of conduct in order to prevent over-lending to individual borrowers, to conduct more ethical microlending, as well as to create social benefits and promote financial inclusion in the country.

MFIN states the core values of its code of conduct that all member should follow: These core values include such important aspects of microfinance activities as:

- integration of low-income citizens to financial services,
- providing quality services to clients

- providing complete and accurate information
- providing fair practices against fraud, misrepresentation, deception or unethical practices
- protecting privacy of client information
- integration of social values into operations
- creation of feedback and grievance redressal mechanism

Later, the second SRO Sa-Dhan developed its own code of conduct titled “Core Values and Voluntary Mutual Code of Conduct for Microfinance Institutions”, which is also directed to the core values mentioned above.

Actually, RBI has issued its guidelines on Fair Practices Code for NBFCs-Grievance Redressal Mechanism in March 2012, and SROs developed their Code of Conduct based on the requirements and recommendation from this guideline.

Summary

Analyzing the experience of foreign countries in microfinance, we can identify the main common features of microfinance activities abroad.

Different countries have diverse organizational and legal form of institutions, which provides microfinance in foreign countries as credit unions, commercial Banks, non-governmental organizations, leasing companies, National Bank, associations, self-organized group, supplier, traders, etc.

Regulation of the activities of microfinance entities also differs depending on the issues this regulation solves as well as effectiveness of distinct type of regulation in a country.

From above discussed countries, all have regulation directed to such main issues as high or so called “exploitative” interest rates, implicit extra charges by MFIs, and absence of disclosure full information on loan conditions to borrowers. Both developed countries such as United States, German, France, UK, and developing ones as Bangladesh, India, have issued legislation regarding these issues. Particularly, in all these countries there are interest rates caps that are set to prevent loan sharking practices and some unscrupulous MFIs’ desire to earn extra high profits.

Regarding the combination and specific of different types of regulation, we can state that there are three main patterns: (1) there are countries such as Bangladesh where there is total state regulation of all organizations involved in microfinance; (2) There are also countries such as United States, Germany, Poland, Hungary, in which there are no specific regulation for MFIs and government agencies regulate the activities of only large organizations, since the latter provide clients with microfinance services and present a certain potential threat to market stability of the

country; (3) there are countries such as India, where there is self-regulation of microfinance activities. This does not mean directly that the organization exists by itself without any regulation, rather it as a rule establishes internal control rules, corporate governance rules and disclosure. From one side, the state tries not to interfere in management, since micro-agencies are not sources of potential systemic risk, and the regulation is not financially justified. In addition, the requirement of reporting is kept, however the state does not implement prudential supervision. In India the need for self-regulation is also comes from the fact that there is huge diversity of microfinance providers, and the regulator could not manage the regulation of all participants of the market.

Trying to answer the question when and how self-regulation failed or succeeded, we should state that there is a general pattern noticed in all countries discussed in this chapter. When the number of microfinance institutions and microloan portfolio grow in a country, the abuses regarding different non-benevolent practices by MFIs also grow. As a rule, this circumstance makes countries to go to more structured and authorized industry regulation, which we saw in all countries discussed.

From one side, the very argument that state regulation is directed to the prevention of unethical or illegal practices and customer protection, justifies the state regulation effectiveness, and all above mentioned countries adopted this strategy of industry regulation. However, from the other side, when the regulation is not directed to the balanced and thorough analysis of business of MFIs, such regulation might be very ineffective and harm MFIs' sustainability.

Chapter 3. Regulation and self-regulation of microfinance organizations in Russia

In this chapter, we will try to apply our theoretical framework to the microfinance sector of Russia. In section 3.1 we will describe the development of this market in Russia and from where it takes its roots. Then we will go to discuss the ethical issues and unscrupulous practices of the industry as well as will make brief market overview to show the overall picture of microfinance market in Russia in section 3.2. Afterward, we will turn to the discussion of the main legislation regarding MFIs' activities and regulation in section 3.3. We will try to describe the key issues that the existing legislation tries to regulate. Finally, in section 3.4 we will describe the role of SROs in the process of self-regulation, trying to specify the main functions of SROs regarding effective self-regulation of MFOs.

3.1. The history of microfinance development in Russia

Origins of microfinance in Russia

The manifestations of microfinance can already be found in medieval history. According to a number of researchers, the first microfinance organizations in Russia can be considered monasteries, which were the largest creditors of the time. But it should be borne in mind that the main borrowers of the monasteries that let the accumulated capital "grow" were merchants rather well-off, or at least business people, who offered considerable profits on the invested funds even in combination with significant risk (Mamuta 2009). It is true that the monasteries gave money and the poor - but they were more regarded as social programs, since no one particularly expected either a high return or a profitability of operations.

From the history of Tsarist Russia, we know that like current microcredit organizations, in 19th centuries in Russia emerged so called credit unions and partnerships that could be considered as a prototype of current microcredit institutions of Russia. It happened after the abolition of selfdom in Russian Empire in 1895, when lots of small owners were in a dire need of loan capital. Taking loans from The State Bank, these partnerships begun distributing funds between peasants, artisans and small traders whose solvency they were able to assess. By the end of 19th century, there were near 700 such mutual credit societies with overall 6,500,000 rubles (Ezrokh 2013).

At the beginning of the 20th century, the cooperative financial movement reached its heyday in the Russian Empire, uniting by 1913 more than 12 million citizens and entrepreneurs.

The average loan size in this system is about 300 rubles, which at that time is a significant amount (Mamuta 2009). Then the ways of development of cooperative finance in Russia, Europe and North America differ - financial institutions were destroyed and preserved only in the form of its meager similarity in the form of "mutual funds" in Soviet enterprises, while in the West, cooperatives are not simply step by step cover municipalities, but also become one of the main financial institutions of local development.

However, in 1930s these credit cooperatives practically collapsed, after which almost 60 years USSR State Bank performed all functions of lending to individuals and legal entities. The main types of loans were so called "working credit": (1) short-term (before the salary); (2) long-term (up to 6 months). And its size could not exceed 50 and 150% of the borrower's salary, respectively. Long-term loans were issued exclusively shareholders of consumer cooperation. In the years 1925-1926 in structure of the working credit was dominated by the petty- (62%), while the long-term share accounted for 38% (Ezrokh 2013).

During the existence of the USSR pawnshops did not were of such a leading importance both in the Russian Empire: for 1984, the volume of loans pawnshops was 630 million rubles, while the cash mutual assistance granted 1,777 million rubles. In USSR there was many mutual aid cashboxes MACs: as of 01.01.1998 - 97.4 thousand units. The average capital of which was 13.5 thousand rubles. The average number of members of the MACs was 110 people. The membership to MACs was not difficult, only 0.5% a month deduction from wage. If necessary, the member of the association could receive a short-term (up to a salary) or long-term loan on preferential terms, i.e. without accrual of interest. The value of long-term loan was limited to 10 months when borrowing more than 300 rubles. (Ezrokh 2013).

Microfinance progress in 1990-2010

When the microfinance market was established in Russia, the American model also was taken as a basis, and emphasis was placed on the development of private entrepreneurship. As a result, numerous consumer and rural cooperatives began to appear after. The shareholders of these funds unite their temporarily free funds to use them for issuing microloans to their members under guarantees or pledges. Those, in turn, could use this money for business development or consumer needs.

The law "On State Support of Small Entrepreneurship in the Russian Federation" established the direct impact of the state on the microfinance sector through the State Committee on Support and Development of Small Business. Later in 2000, the committee was disbanded due to its inefficiency, and its functions were transferred to the "Antimonopoly Service". The Law and

the activities of the Committee have brought to life numerous budget and private funds supporting small businesses, most of which currently carry out microfinance activities.

However, the German model for the development of the microfinance sector was also applied in Russia, which was represented by the structure of interaction between JSC “Russian Bank for SME Support” (SME Bank) and microfinance institutions.

While some authors posit that Russian microfinance takes roots from American model, the others argue that German prototype is also applicable for Russian microfinance. Trying to escape such a contradiction among scholars, we would better to identify Russian model of microfinance development with the help of explanation offered by Yakunin and Gorskaya (2012). According to these authors, a large differentiation of the standard of living in different regions allows to conclude that while in one region MFIs create workplaces, in others it is a way to get out of poverty. Therefore, to talk about preference in using development of a particular model in Russia is not a right decision.

Even though the Federal Law "On Microfinance Activities and Microfinance Organizations" came into existence only in 2011, microfinance organizations have been operating in Russia for quite some time.

A new stage in the activity of credit cooperatives began in the 90s of the 20th century, when the command economy warped, and emphasis was placed on the development of private entrepreneurship. In the new Russia, numerous consumer and rural cooperatives began to appear, the shareholders of which unite their temporarily free funds to use them for issuing microloans to their members under guarantees or pledges. Those, in turn, could use this money for business development or consumer needs.

However, such organizations did not enjoy wide popularity because of mistrust on the part of ordinary citizens. Many Russians still remember how in those years the pyramids like “MMM” “boomed”, which deprived many citizens of their last savings. Basically, during these years microfinance organizations earned its “weird and unscrupulous” reputation that was fixed in collective mind of people till now. Even nowadays the legacy of this distrust toward microfinance organizations continues to exist among the population. However, despite this, microfinance continued to exist and grew.

Another factor explaining such an unkindly reputation of MFIs among Russians is that fact that the market was not regulated at all started from very 1990s until 2010 when the law came to existence. During these years, virtually everybody was able to be engaged in such kind of activities, lending high percent loans to people needed money for various reasons. Very often, the return of these loans was not done in a legal way, and the creditors were using both phycological and physical force to influence on borrowers to return debts.

As a result, without regulations, State control and established rules, many individuals and entities were engaged in micro-crediting, and created enormous wealth on the others “grief”.

It’s noteworthy that this period, as well as the period of the first half of the 2000s, is characterized by an absence of legislative base regulating the functioning of these organizations. As a result, lots of inevitable uncertainties regarding the interaction of organizations with customers emerged shading the development of microfinance market in general.

For the first time, the activity on granting loans to legal entities that are not credit institutions was evaluated in the information letter No. C1-7 / OP-555 of the Supreme Arbitration Court of the Russian Federation of 10.08.1994 "On Selected Recommendations Adopted at Meetings on Judicial Arbitration Practice" (hereinafter - information letter) issued even before the adoption of the Civil Code of the Russian Federation.

Paragraph 4 of this information letter clarifies that when the organization provides its free funds under a loan agreement, including conditions of payment of certain interest, if such activity is not directly prohibited by law and is not systematic, a license for banking operations is not required.

Basically, the “Civil Code of Russian Federation” adopted in October 1994 and the law “On non-profit organizations” issued in December 1995, accompanied by the law “On State Support of Small Entrepreneurship in the Russian Federation” adopted in May 1995, were the only legal documents that somehow regulated microfinance activities in Russia up to 2010.

While the article №160 of Civil Code was about written form of transactions stating the conditions of contacting between interest sides, the article №7 of the law “On non-profit organizations” was about funds and in which activities these funds could be engaged.

The real growth of the microfinance market in Russia began in 2004, when the economic situation in Russia stabilized after the crisis of the 1990s. So, if in 2003 there were only 150 organizations engaged in microfinance, by the end of 2008 there were already 2750, and by the end of 2011 - about 9000²⁹. This growth was a consequence of increased solvency and creditworthiness of individuals and SME entities.

As the number of participants and microfinance market grew, the need for organization of the segment grew as well. For this purpose, **Russian Microfinance Center (RMC)** was created in 2002.

²⁹ Source from monitoring reports of Russian Microfinance Center, resource available at http://rmcenter.ru/analitics/materialy_i_publicatsii/

So far RMC assists the poor and socially unaffected population in Russia to win poverty through business development and initiative, the RMC takes an active part in charitable activities, raising the standard of living in Russia³⁰.

RMC serves as a resource center for the microfinance sector and a kind of middle unit among microfinance institutions, government, society and investors. The center also helps to the formation of a favorable legal environment, provides professional training and consulting services to microfinance organizations, and promotes the implementation of national microfinance standards.

Later, **The National Partnership of Microfinance Market Participants (NAUMI)**, registered on April 7, 2006 by The Association of Russian Banks, The Association of Small and Medium Business Support Agencies "DEVELOPMENT", The Russian Microfinance Center and the National Association of Non-Profit Organizations for Financial Mutual Assistance.

The partnership develops standards of microfinance activities with participants and promotes their implementation, supports the development of new technologies for microfinance services, promotes the formation of a positive image of microfinance activities, performs representative functions in the interests of its participants.

Basically, NAUMIR carries the responsibility of so called “political” part of the job organizing business events at the federal and international level and providing the interaction of legislative and executive authorities, public organizations, microfinance institutions and their associations, as well as mass media.

3.2. Microfinance industry overview and existing ethical issues

Currently, in Russian Federation Microfinance Institutions include such entities as pawnshops, credit consumer cooperatives, agricultural consumer credit cooperatives, housing funded cooperatives, microfinance organizations and microfinance organizations of business financing.

³⁰ <http://rmcenter.ru/about/>

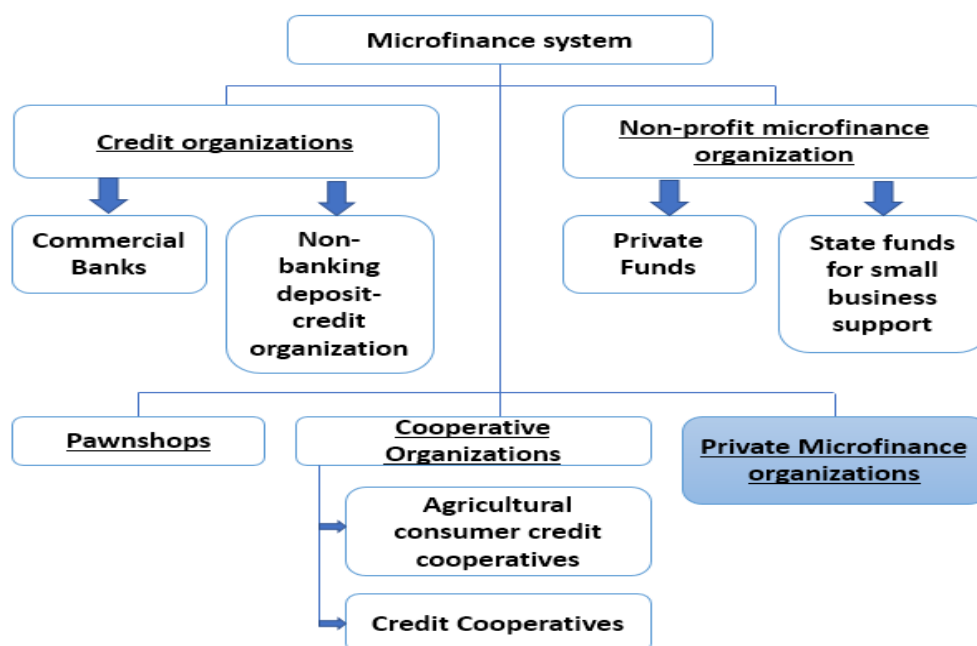


Figure 2: Structure of the microfinance segment in Russia³¹

The main target groups for Russian MFOs are Small and Medium Enterprises (SME), Individual Entrepreneurs (IEs) and low-income individuals.

Basically, there are three major segments in which Russian MFOs are operating: (1) Ones that give microcredits to small and medium business. The credit amount is constrained by 1 million rubles usually for maximum 1 year; (2) MFOs that give Pay Day Loans in amount of 1-20 thousand rubles at 1,5-3% a day for very short term, and finally (3) MFOs that lend consumer loans from 10 to 100 thousand rubles at 7-21% per year for maximum a half year. The share of overdue loans for first group is dramatically low, while for PDL segment the same measure is 20-25% and for MFO giving consumer loans is 15-18% (Solodukhina 2015).

According to The Bank of Russia's annual report on 2017, there were registered **2271 organizations by 01.01.2018**, while there were 2588 organizations by 01.01.2017. As we can see, the number of registered MFOs decreased 12,25% during 2017. Regarding the membership of MFOs to SROs, 2145 organizations were members of 3 SROs at 01.01.2018, while there were 2379 organizations-members of SROs at 01.01.2017 (Annual report 2017).

As of 31.12.2017 **the aggregate portfolio** of microloans increased by 28.0% and amounted to **112.8 billion rubles**. However, by 01.01.2018 among the number of MFOs only 60 are registered as MFCs and 2157 as MCCs. Despite this huge difference in quantity, by 01.01.2018 MFCs earned 52.4% of total profit of MFOs.

³¹ Source from Starostin 2014

In the portfolio of MFIs of consumer microfinance, the share of non-serviceable over 90 days of microloans (NPL 90+) was 30.3% (Annual report 2017). At the same time, this value in the MFI sector declined by 8.9 percentage points since the beginning of 2017, which was due to the outstripping growth rate of the portfolios of the largest MFIs (including the segment of online microloans). The cumulative increase in the portfolio of micro-loans was provided mainly due to the inflow of borrowed funds from legal entities (other than credit institutions) and individuals (including founders), the amount of debt to which increased over the year by 46.5 and 28.1%, respectively

The share of funds provided by individuals or individual entrepreneurs (non-founders) in the total amount of funds raised from individuals or individual entrepreneurs was 94.7% for the MFCs and 10.2% for the MCCs.

Before stating the main ethical problems that currently exist in the industry, it would be better to describe briefly the attitude toward the industry.

Generally, MFOs are believed to be addressed by people with insufficient creditworthiness, with a damaged credit history and with high credit load. In general, these are people who were denied by banks for diverse reasons. But this statement is not always true, as the high availability of microcredit, along with the convenience of receiving it, allows an ordinary citizen to take a loan for any needs without explaining the purposes.

Very often, people getting attractive offers from microfinance organizations, misjudge their own financial opportunities to return the borrowed money, which then have a “prison effect” on them. As the credit amount is doubled or tripled due to high fines and penalties, people find themselves locked taking loans again and again to pay the previous ones, a phenomenon called “Financial Funnel”. The amount of the debt grows and eventually a person becomes insolvent. And Yunus’s basic idea of social microfinancing turns to be a disaster for number of individuals in micro level and for social-economic progress of the country in macro level.

Regarding the main ethical issues and unscrupulous practices that MFOs are abused for, we will adhere mainly to the paper of Solodukhina (2015), as it is the most recent work thoroughly analyzing the ethical issues of current microfinance industry in Russia. Moreover, Solodukhina’s paper is focusing on Pay Day Loans segment, which receives the biggest part of abuses regarding unscrupulous practices toward customers.

Therefore, the research done by Solodukhina revealed the following specific problems:

- Information asymmetry (opacity) - In most cases Russian MFOs do not disclose the essential characteristics of the proposed product (such as penalties, repayment scheme, possibility of extension or early repayment, etc.),
- High interest rates (more than 600% annual in PDL segment),

- Unscrupulous collection practices,
- Signing of application-offer, after which a consumer signing the application, simultaneously subscribes to the fact that all the terms of the loan are known to him, and most importantly, that he is aware of the consequences of non-performance,
- Limiting the possibility of early repayment. The possibility of early repayment in the vast majority of cases is limited to one or another of the conditions - from the need to warn the lender to the explicit prohibition of redemption within a certain period and the imposition of penalties,
- Non-compliance with the principles of responsible lending. MFOs do not find out whether the structure of income and expenses allows the borrower to repay the debt on time,
- Disproportionately high fines,
- Lack of alternative solutions for low-income people who are in need,
- Aggressive marketing policy - MFOs use several techniques to attract customers, which can be unambiguously classified as aggressive and even viral marketing activities.

Above mentioned problems are the most common and the most discussed issues that relate to current microfinance industry. So, the regulation of the industry should be directed to prevent these unethical issues and practices.

3.3. Main legislation affecting microfinance organizations in Russia

Currently, in Russian Federation Microfinance organizations are regulated by several state laws as well as normative acts of Bank of Russia.

As already noted, current microfinance in Russia was developed after Soviet Union breakdown, however the law on microfinance organizations was issued when the industry matured enough. So, the **law №151 "On Microfinance Activities and Microfinance Organizations"**, adopted in 2010, helped to get rid of many fraudsters and made the activities of MFOs more transparent. It was from 2010 in Russia that the era of “civilized” microfinance, controlled by the state, began. And the state represented by the Federal Service for Financial Markets at the beginning and by The Bank of Russia from September 1, 2013, is increasingly monitoring this developing market.

The law states “a microfinance organization is a legal entity that carries out microfinance activities and information about which is included in the state register of microfinance organizations in the manner provided for by this Federal Law. Microfinance organizations can operate in the form of a microfinance companies or microcredit companies” (FL №151). Many

experts believe that this division of microfinance institutions in two groups is one of the most major changes in the context of MFO regulations directed to the recovery of the whole market.

The law clearly distinguishes between two types of microfinance organizations. Microfinance Companies (hereinafter MFCs) should have 70 million rubles own capital, can take deposits from individuals for an amount not less than 1.5 million rubles, and the maximum amount of microcredit is 1 million rubles. From the other side, Microcredit Companies (hereinafter MCCs) are not allowed to admit deposits from individuals and to credit online, have a 500.000 rubles limit for crediting and are free from own capital requirement. However, both types of organizations are controlled equally by the Law “On Microfinance Activities and Microfinance Organizations”, by the Law “on Consumer Credit (loan)” and by other normative acts of Central Bank.

The law states, for example, the criteria for funders and management of microfinance organizations, and in this way dramatically reducing the access of unscrupulous participants into the industry. Also, in the law there is a separate article on self-regulated organizations and the requirements for all microfinance organizations to member SRO. According to the law “A self-regulating organization in the financial market realizes control over compliance by the microfinance organizations that are members of this self-regulatory organization with the requirements of this Federal Law and the regulatory legal acts of the Russian Federation adopted in accordance with it and the regulations of the Bank of Russia”.

The law then states the details of lending conditions such as currency of a loan, some internal documentation specifics, the procedure of contracting, and also rights and responsibilities of both microfinance organizations and borrowers

More importantly, the Law states in Article 12.1 the features of accrual of interest and other payments in case of delay in performance of loan obligations. According to this article “after the appearance of the delay in the fulfillment of the obligation of the borrower to repay the loan amount and/or the payment of the interest due, the microfinance organization, under the consumer loan agreement, the repayment period of the consumer loan for which does not exceed one year, may continue to charge the borrower but only the part of the principal amount.

Interest on the portion of the principal debt that is not repaid by the borrower continues to accrue until the total amount of the interest payable is equal to the amount of the double amount of the outstanding portion of the loan.

In its turn, Federal **Law №353 "On consumer credit"** issued in December 2013 specifies that all professional creditors, including banks, MFOs, pawnshops and credit consumer cooperatives, are required to follow uniform rules for issuing loans, which leads to a higher level of consumers' rights. At the same time, microfinance organizations are obliged to disclose to their

customers the cost of credit, that is, the amount of overpayment for the use of loan funds. In turn, citizens can simply compare the interest rates of different MFOs and choose the best option.

Based on the Law "On consumer credit" The Bank of Russia quarterly calculates and publishes the average market value of the Full Cost of Credit (hereinafter FCC) by categories of consumer loans separately for all microfinance institutions, including microfinance organizations. According to the publication on 2nd quarter, the average FCC for consumer microloans without collateral, with an amount no more than 30 thousand rubles and for less than 30 days, is 615,064% and marginal FCC for the same period is 820,085³². For consumer microloans with collateral in the form of pledge, average FCC is 77,501%, marginal FCC is 103,335%.³³

Beside the FL №353 gives very detailed information and states requirement for consumer loan contract conditions such as the types of consumer loans, amounts and periods of loans, currency of loans, ways of lending including electronical means of payment, yearly interest rates, range of Full Cost of Consumer Credit, periodicity of repayment, and other kind of information on loan conditions. Regarding FCC requirement, microfinance organizations and traditional banks are obliged to expose the information about FCC on right upper angle of the first page in every consumer loan contract. The purpose of this requirement is to focus all consumers attention to the full cost of credit that they are going to borrow.

Self-regulatory organizations of microfinance organizations in the first edition of Law No. 151 were mentioned only twice - when approving the list of rights of the authorized body. SRO was granted the right to maintain a register of SRO MFIs and interact with them.

In practice, this meant voluntary self-regulation and the right microfinance organizations to create self-regulating organizations within the framework of the general rules of **Federal Law No. 315-FL of 01.12.2007 "On Self-Regulating Organizations"** (hereinafter - Law No. 315-FL).

Adoption of mandatory rules and standards for members of SRO MFOs in conditions of voluntary membership in SRO MFOs hardly had a significant value in solving sector problems, since introduced requirements only for some of the participants in this financial market (Chirkov 2017). It seems that this approach cannot eliminate the problem of a decision that aims to introduce the relevant requirements of the rules and standards of SRO MFOs, and also creates regulatory arbitration (various regulation of the same activity). Probably, for this reason, many documents of

³² Average market values of the Full Cost of Consumer Credits (Loans) for the period from October 1 to December 31, 2017 - used for consumer credit (loan) contracts concluded in the II quarter of 2018 by microfinance organizations with individuals

³³ Ibid

the SRO of MFOs were quite controversial from the point of view of Law No. 315-FL, the nature of the recommendations.

The insolvency of the idea of ensuring property liability of SRO MFOs for the obligations of their members is possible just illustrating with only two figures. As of 01.10.2015 the size of the compensation fund of the largest SRO MFO – SRO "Microfinance and development" (in Russian SRO “MIR”), which at that time combined 150 MFO-members, was 410 thousand rubles (Chirkov 2017). Consequently, its size is not covered even half of one minimum possible obligation to one individual of one member of the SRO MFO.

Therefore, it could be concluded that the system of voluntary self-regulation of the activities of microfinance organizations allowed to achieve the goals defined by Law No. 315-FL, was not effective from the point of view of ensuring the protection of consumer rights of services microfinance organizations and standardization of microfinance activities. Actually, existing SROs within the framework of Law No. 315-FL carried out the functions of professional associations and did not performed a role that in the literature prescribes self-regulating organizations as institutions of civil society. In addition, SROs were not under the supervision of the Bank of Russia, in fact there was no possibility of its influence on the SROs, which significantly reduced the potential functions of SROs.

The situation in the field of self-regulation of the activities of microfinance organizations has changed in connection with the adoption and entry into force of the 11.01.2016 of the **Law No. 223-FL on “self-regulated organizations of financial market”**, according to which a microfinance organization is required to be a member of SRO only in the case of presence of a self-regulatory organization of the appropriate type.

Internal standards of SROs in content and legal nature are similar to the "rules and standards" under Law No. 315-FL. The basic standards, which, by virtue of Article 5 of Law No. 223-FL are mandatory for all microfinance organizations regardless their membership in the SROs, are presented in principle new in nature acts. Basic standards for their nature are not local acts, as standards of SROs are classified in the special literature and regulatory acts. They go beyond self-regulation, establishing requirements for MFOs that are not members of the SROs.

According to the Law № 223, MFOs are obliged to join one of the Self-Regulated Organizations. By 16 February of current year overall 2124 MFOs are member of one of three SROs (MIR, EDINSTVO, ALIANCE)³⁴.

The law №223 states that the goals of self-regulated organizations are 1) the development of financial market, stability and efficiency of the industry, 2) Implementation of economic

³⁴ https://www.cbr.ru/finmarket/supervision/sv_sro/

initiatives of SROs' members, 3) protection and representation of the interests of the members against Bank of Russia and other federal authorities.

Also, the Law postulates the standards of self-regulated organizations, which are the documents that set requirements for the member of an SRO and regulatory relations between SRO members, and between SRO members and their clients as well. The Article №5 of the same law, clarifies the main requirements on Basic Standards that SROs should issue and agreed by Bank of Russia.

According to another article of the same law, Bank of Russia in a writing form transfer its authority to SRO to gather the reports from its member in a defined period and way. The Law also states that microfinance organization could be a member of only one SRO, as well as other conditions and details how MFO should enter and leave an SRO.

There are other laws that not directly relate to the regulation of the relationship between a creditor and a borrower, but the ones above are probably enough for any borrower to enhance its financial literacy in the microfinance segment and get qualified financial service.

Regarding the main limitations that Bank of Russia set on microfinance organizations, include measures such as: (1) limitation on Full Cost of Consumer credit (the allowable excess of the "market average" by 1/3 for the corresponding category of the loan); (2) limitation on the size of charged fines and penalties (for violations of the performance of obligations under consumer loan agreements (no more than 20% per annum or 0.1% per day, depending on the accrual of interest); (3) a single limitation of the borrower's maximum debt under a consumer loan contract in relation to the amount of consumer loan in the amount of 2.5 times the amount of consumer credit; (4) a daily interest rate cap with the simultaneous limitation of the FCC.

In February of current year, Bank of Russia made public its recent suggestions regarding future limitations directed to the development of the industry during fourth international microfinance conference on financial literacy and financial inclusion.³⁵

The main changes that were suggested by Bank of Russia are:

- to establish a unified limitation of the borrower's maximum debt under a consumer loan contract in relation to the amount of the consumer loan (hereinafter referred to as the "Ratio") in the amount of 2.5 times the amount of the consumer loan, and also to prohibit the achievement of this coefficient on accrual and collection of interest for the use of consumer loan, penalties, fines, other payments and application of other measures of liability to the borrower.

After introducing a 2.5x coefficient to continue further limiting the borrower's marginal debt continue to set up 2x coefficient from 01.07.2019, and 1,5x coefficient from 01.07.2020.

³⁵ <http://finfin.rmcenter.ru/#program>

- to impose a daily interest rate cap of 1.5% per day, and from 01.07.2019 reducing the daily interest rate to 1.0% per day.
- to introduce new specialized product (a loan without collateral, for a period not exceeding 15 days, for an amount not exceeding 10,000 rubles, with ban on prolongation and increase in the amount of consumer loan, and with fixed amount of payments: the amount of accrued interest for the use of consumer loan, penalties, fines, other measures of liability and payments not exceeding 3000 rubles for the issuance of a loan worth 10,000 rubles).

3.4. The role of self-regulated organizations in microfinance industry regulation

Currently, in microfinance industry one of the priorities for the state is to fight microfinance organizations that operate illegally. This task is relevant because such creditors do not contribute to the development of the microfinance market and discredit the activities of bona fide microfinance organizations.

To implement the above task, the legislator has made some changes to the regulatory legal acts governing the activities of organizations that issue retail micro-loans.

So, according to the provisions of the Federal Law № 223 "On self-regulated organizations in the financial market", all organizations operating in the financial markets should join self-regulated organizations. Moreover, in accordance with the above-mentioned Law, "the obligation to join the SRO comes from the microfinance organization for 180 days following the day of the onset of one of the events: (1) the receipt by the non-profit organization of the status of a self-regulatory organization of the appropriate type in the absence of a self-regulatory organization of the relevant type before the specified date; (2) termination of their membership in a self-regulatory organization".

On March 10, 2016, the Central Bank included two SROs: the SRO Microfinance and Development (**SRO MiR**, Moscow) and **SRO EDINSTVO** (in Kazan) in the single register of self-regulated organizations in the financial market with respect to the type of activity of microfinance organizations. Accordingly, in order to implement the obligation stipulated by the Federal Law, by September 6, 2016, all MFOs were required to become members of one of the three registered SROs (apart from the two mentioned above, the Microfinance **Alliance** "Institutions for Small and Medium Business Development"), functioning in the microfinance industry.

These SROs are entrusted, according to the provisions of the above-mentioned Law, with two main functions: **primary control of MFOs and development of basic standards** for their

activities. Hence, it follows that SROs conditionally performs the function of the mega-regulator (Bank of Russia), which certainly contributes to the effective work of all its participants (Semenova 2016).

As for the Bank of Russia, it establishes requirements for basic standards, and oversees the proper implementation of SRO functions to monitor the activities of MFIOs.

The self-regulatory organization should develop draft standards for the following types: (1) on risk management; (2) corporate governance; (3) internal control; (4) protection of the rights and interests of individuals and legal entities - recipients of financial services provided by members of self-regulatory organizations; (5) transactions in the financial market.

These basic standards developed by each self-regulating organization uniting MFOs, once agreed by the standards committee under the Bank of Russia, will be mandatory for all MFOs, regardless of their membership in a particular SRO.

The fact that an SRO has the right to make any proposals to the Central Bank, as well as to develop work standards, positively affects the lives of both lenders and borrowers, and also contributes to the overall development of the financial services market.

The entry of microfinance organizations into the SRO more likely will have a positive impact on their activities, since all microfinance organizations that have membership in SROs have certain advantages and provide additional guarantees for borrowers' rights, which significantly increases the demand for their loans from consumers.

First, such organizations can easily place their advertising, while other organizations cannot always take advantage of such a right, which negatively affects their lending volumes. Secondly, borrowers have more confidence in MFOs, who are members of SROs, because they are not afraid of fraud. And, thirdly, since today there are cases of bad faith of creditors who carry out their activities illegally, it is only by participation in a self-regulating organization that a creditor can prove his conscientiousness towards the consumer.

In the context of this research, we will stick to SRO MiR while analyzing the main functions of SROs as well as the standards they issue.

Regarding the foundation of SRO MiR, we should briefly describe the main steps of transformation SRO MiR after the Law on microfinance organizations was issued in 2010. So, with the purpose of assisting members of the partnership to carry out activities in the field of microfinance and completely supporting the formation and integrated development of microfinance organizations, in 2011 Non-commercial partnership of microfinance organizations "Microfinance and Development" (NP "MIR") was created by the largest participants of the microfinance market.

To fulfil its goals, the partnership planned to promote the development of legislation in the field of microfinance and the legal regulation of MFO activities, to develop and implement standards for microfinance activity, to monitor and survey MFOs, to provide organizational, informational, analytical, methodological, legal and other assistance to the members of the partnership, to expand contacts between MFOs and MFO specialists, to form a favorable public opinion on microfinance activities, etc.³⁶

Later, NP “MIR” transferred its functions to NP “**Union of MIR**”, which in its turn was merged into newly created SRO “**MIR**” after April 2014.

It should be stated, however, that before the law “On self-regulated organizations in microfinance market” came to existence, the membership in NP “MIR” and later in NP “Union of MIR” was implemented on voluntary basis, while a membership to SRO “MIR” is mandatory according to the law from 2015. Accordingly, the relationship between SRO and its members is driven by high mutual interests for cooperation and integration, since the majority of the members joined SRO before all microfinance organizations were forced by the law to join on of SROs.

Currently, SRO “MIR” actively engaged in such tasks as³⁷:

- Assistance in resolving issues arising from interaction with regulatory body
- Assistance in bringing internal documentation into line with the requirements of regulatory legal acts
- Legal support in the course of inspections
- Developing and implementing business standards in practice
- Protecting consumers' rights in the microfinance market, including involving a financial ombudsman to resolve disputes
- Participation in the development of regulations affecting the interests of SRO members.
- Work with the media, including the Internet
- Publication of materials of SRO members in the profile journal "Microfinance +" and on the portal rusmicrofinance.ru
- Work with complaints from clients of MFIs, including with the involvement of the financial ombudsman.

The leadership of SRO "MIR" states that one of the most important goals of SRO is to create and strengthen a positive image of MFOs (primarily SRO members) in the eyes of potential clients, as well as in the eyes of governmental officials.

³⁶ <http://npmir.ru/about/np-mir/>

³⁷ <http://npmir.ru/about/sro-mir/index.php>

Regarding the second main function of SROs - development of basic standards for microfinance activities – SRO MiR was engaged in the process of standard development with Bank of Russia and other partners since its funding.

So, in 2013, in association with “National Association of Professional Collection Agencies” (NAPKA), NP “MIR” worked out and published **“The code of ethics and standards of work with long-term debt on microfinance market of organizations”**.

The Code of Ethical Standards establishes and defines the basic principles by which MFOs and professional collection agencies should be guided in their professional activities to claim debt on loans granted. These principles are based on the norms of legislation, morality, as well as international standards of collection activities and business practices in the microfinance sector³⁸.

As stated in the Code, the provisions of this Code carry a recommendatory and not mandatory character for MFIs - members of NP "MIR" and for Agency members of the NGO "NAPKA", working in the field of collection of overdue debts under contracts with MFOs.

The next step in standard development was the issue of **standards for “Cessional transactions in microfinance market”** in 2014. These Standards have been developed and approved in order to establish common professional and ethical rules of transactions on the assignment of claims under micro-loan agreements on the microfinance market, taking into account interests, as parties under the Assignment Agreement, and debtors-borrowers of MFIs, whose observance promotes the civilized development of the microfinance market (Standard 2014).

Standards for “Cessional transactions” were designed to ensure: (1) creation of transparent conditions for the tendering procedure for the selection of buyers for MFOs; (2) determination of the basic rights and obligations of the parties under the Assignment Agreement at the stage of its conclusion and execution; (3) systematization of provisions that take into account the interests of both MFIs and buyers on cession contracts; (4) coordination of the main issues arising in concluding cession agreements, in particular, the establishment of their standard conditions; (5) the procedure for determining the fair price under the Assignment Agreement; (6) avoidance of possible risks in the evaluation of assignments portfolios; (7) achievement of the most effective recovery in the framework of the Assignment Agreements.

On 22 June of 2017, the Bank of Russia approved Basic Standard on **“protection of the rights and interests of individuals and legal entities - recipients of financial services rendered by members of self-regulating organizations in the financial market that unite microfinance organizations”** (Standard 2017).

³⁸ https://www.cbr.ru/finmarket/supervision/sv_sro/

This Standard was adopted to: (1) ensuring compliance with the rights and legitimate interests of recipients of financial services provided by microfinance organizations; (2) preventing unscrupulous practices of interaction between microfinance organizations and recipients of financial services; (3) increasing the information openness of the microfinance market in the Russian Federation, as well as raising the level of financial literacy and awareness of financial service recipients about the activities of microfinance organizations; (4) improving the quality of financial services provided by microfinance organizations, as well as creating the conditions for effective control by self-regulating organizations in the financial market of the activities of microfinance organizations.

The standard is based on the norms of the legislation of the Russian Federation and is mandatory for use by microfinance organizations, regardless of their membership in a self-regulatory organization and acts in a part that does not contradict the legislation of the Russian Federation, including regulatory acts of the Bank of Russia. A microfinance organization must include in the agreement with a third person acting on behalf of, on behalf and at the expense of such a microfinance organization, provisions that oblige such third party to comply with the requirements of this Standard.

Finally, on 27 April of current year, Basic Standard on “**the performance of operations by microfinance organizations in financial market**” (Standard 2018).

The Standard establishes the conditions and procedure for the following transactions in the financial market subject to standardization in respect of microfinance organizations: (1) issuance of microloans; (2) attraction of funds from individuals.

The standard is mandatory for all microfinance organizations, regardless of membership in a self-regulatory organization in the financial market that unites microfinance organizations and operates in a part that does not contradict the legislation of the Russian Federation and regulatory acts of the Bank of Russia. The standard sets the main conditions for the implementation of operations regarding microlending, attraction of funds from private customers as well as the order of implementation of microlending operations and attraction of funds, procedures for the evaluation of client creditworthiness.

Summary

As we have seen, microfinance in Russia takes its roots from Tsarist Russian period, then transformed during Soviet Union 70 years, after which started new era of its development since 1990s. The main law on microfinance organizations was issued later in 2010, when the industry

had already matured and well-established. Currently, there are more than 2000 microfinance organizations with credit portfolio of almost 113 bln rubles.

The major problems, that still exist in MFO market and especially in PDL segment, include: low level of financial literacy of consumers, invasive marketing strategy by many MFOs, non-purposeful borrowing, lack of transparency by many MFOs, still high interest rates and fines, lack of alternative sources of financing for many citizens, still lack of control on disclosure of credit conditions by MFOs and “Mission Shift” from some MFOs.

The industry is regulated according to several state laws such as Law “On Microfinance Activities and Microfinance Organizations”, Law “On consumer credit”, Law “On self-regulated organizations of financial market”, as well as number of normative acts and several limitations by Bank of Russia.

Regarding the self-regulation of the industry, SROs have two main functions: primary control of MFOs and development of basic standards for their activities. As stated by SRO MiR, one of the most important goals of SRO is to create and strengthen a positive image of MFOs (primarily SRO members) in the eyes of potential clients, as well as in the eyes of governmental officials.

Chapter 4. Research Methodology

In this chapter we will describe the methodology applied for current research. In section 4.1 will be discussed the used research philosophy as well as the research design stating why the chosen research design is most applicable to current study and what are the research questions. Then, in section 4.2 we will try to prove why the certain sampling strategy was chosen for this research. Finally, in section 4.3 we will describe in detail the main steps of data collection and procedures.

4.1. Research philosophy, approach and design

The five major research philosophies are positivism, critical realism, interpretivism, postmodernism and pragmatism (Saunders et al. 2016). The more appropriate research philosophy for the current research is pragmatism. This philosophy fits to his research context not only because there is not a single philosophy for this context, but also that Pragmatism assumes that the research starts from the problem and intends to find practical solutions (Saunders et al. 2016). As we have real research problem, which requires explorative investigation with the aim of finding solutions, we can state that Pragmatism suits this idea in the best way.

Regarding the research approach for current study, the abductive was chosen as more descriptive. The difficulty to decide whether this study close more to deductive or to inductive approaches, makes us to adhere to abductive approach, which allows us to maneuver from general theory of self-regulation to practical implication of the theory in microfinance industry and vice versa. Additionally, the goal of this study is not to test hypothesis, and the study itself carries highly explorative design, the circumstances that almost exclude the applicability of deductive approach (Saunders et al. 2016).

Additionally, inductive approach is also not favorable for this research, since the concept of self-regulation is widely discussed in the literature and investigated by number of scholars. Likewise, the opportunity of modifying the existing theory and models another reason that abduction is relevant to our research, since our study intends to find new approaches to more effective self-regulation of microfinance industry. Finally, abductive approach is free of constraints that have deductive and inductive methods. Hence, the most convenient approach for this study is abductive method.

To achieve the main goal of the current research, we have developed the following research questions:

- RQ1 - What are the most relevant ethical issues of Russian microfinance organizations which may require regulation?
- RQ2 – What should be an effective approach to self-regulation of the industry to prevent unethical behavior of MFOs?

The stated research questions obviously show the explorative purpose of research design. This type of design is applied usually when the researcher aims to understand nature of phenomenon and gain deep insights about the research problem.

As our study aims to find out solutions and effective approaches to the self-regulation of microfinance organizations, exploratory strategy would allow us to investigate the field deeper and to answer the questions of what, why, how types.

Another reason, that such research strategy fits our study is the fact that the concept of effective self-regulation in microfinance is poorly defined and explored yet. Also, an explorative research strategy is useful for collecting preliminary information in cases when researchers lack verified information in order to set conceptual distinctions or state explanatory relationships (Shields, 2013).

Finally, exploratory research usually starts with a wide focus, but then becomes narrower as the research develops (Saunders et al. 2016). In case of our research, we had a very broad problem as starting point, which requires further investigation. After, we tried to narrow the scope of research to be able to give more thorough and comprehensive answers to the research questions.

The research design chosen for the current study is multi-method qualitative study. There are several reasons why qualitative research design more than other designs correspond to this research.

The first reason is the explorative nature of the design already discussed above. As we aim to find more insight on the research problem, qualitative research will allow us to explore the possibility of developing conceptual framework for more effective self-regulation of microfinance organizations.

Also, qualitative method will allow us to be more flexible in gathering information from participants of microfinance industry. Another reason for choosing qualitative research method is the very sensitive nature of the problem (Malhotra et al. 2012). In our research we want to answer such question as what kind of ethical practices exist in the industry and how these practices relate to the self-regulation of MFOs. All these issues are very sensitive and require qualitative techniques to get meaningful and trustworthy answers.

Finally, for the explorative research strategy qualitative methods could bring to unanticipated meaningful insights that could not be achieved through quantitative research tools.

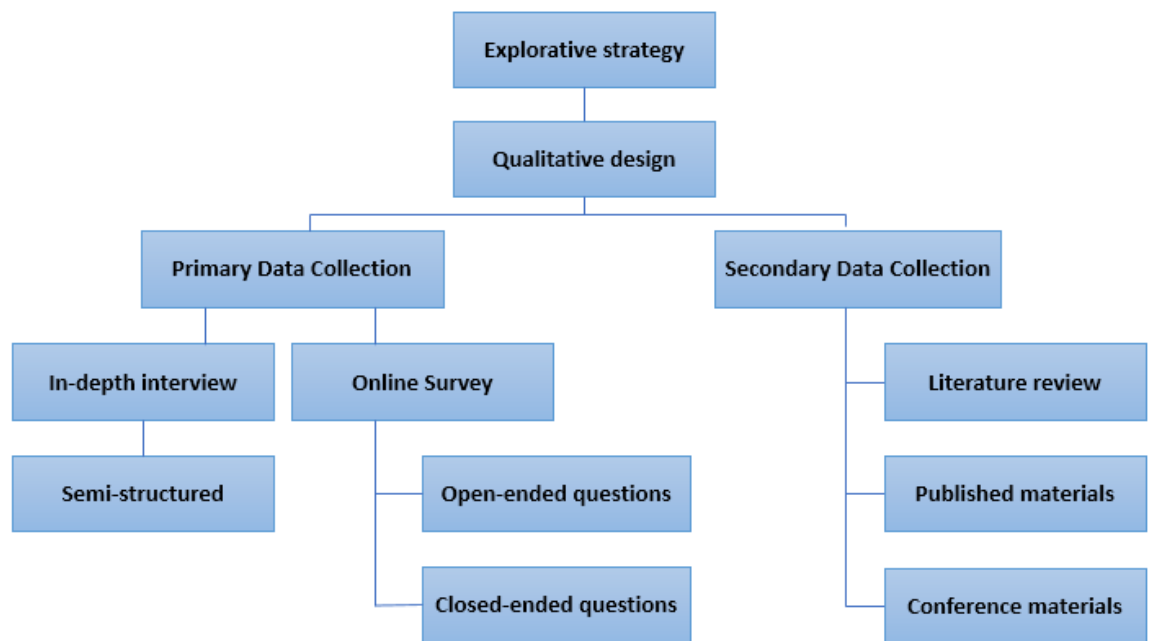


Figure 3: Research design³⁹

4.2. Sample strategy

Choosing a study sample is one of the most important steps in any research project since it is hardly practical, efficient or ethical to study whole populations (Marshall M. 1996). Generally, the aim of all quantitative sampling methods is to draw a representative sample from the population, in a way that the results might be used to generalize it to the population.

The choice of an appropriate method directly relates to the research goal and strategy. Although different scholars specify various classifications of sampling methods, but most of them agree that there are three main sampling methods.

- **Purposeful Sampling** is the most common sampling strategy. With this type of sampling, researchers based on research question, choose participants based on pre-selected principles. The sample size might be chosen predeterminable or based on theoretical saturation technique, which is the point after which a new participant does not provide new insights to the research.
- **Quota Sampling** is a sampling technique when researcher has predetermined number of quotas regarding the number of participants prior to sampling. In these cases, researchers are inclined to gather data from a determined number of participants corresponding to certain characteristics such as age, sex, class, marital status, etc. (Berg and Lune, 2005).

³⁹ Source by author

- **Snowball Sampling**, which is also called chain referral sampling, the participants help the researcher referring them to other participants who may be potential target group for the study. Moreover, this sampling offers researchers assistance in recruitment of new participants that are hard to reach otherwise.

For current research we have chosen purposeful sampling method, as the research problem requires to include in the research process the participants from all interested parties. In this case, these interest sides include representatives of SRO MiR, Russian Microfinance Center, Microfinance organizations. As wrong sampling method could bring to the problem of poor representativeness of the entire population, we included not only the representatives of all interest sides, but also distinguished the participants according to their representativeness, influence in appropriate fields, position, size, the attitude and interest toward the research problem.

One type of the purposeful sampling method is maximum variation sampling, also known as heterogeneous sampling. As obviously shows the name of this sampling type, it is a technique used to capture a wide range of perspectives relating to the research problem. Also, maximum variation sampling helps researchers to seek for variation in opinions and conditions that are viewed as more extreme in their nature to the researcher. The basic principle of maximum variation sampling is to gain greater insights into a phenomenon by observing it from all perspectives.

All these factors made us to choose maximum variation sampling method as the more suitable and relevant for our research strategy.

After choosing a right research sampling method, researchers should determine the optimal sample size which will allow them to enable valid inferences and generalization about the population. From one side, the larger is the sample size, the smaller is the chance of a sampling error, but from the other side, very large sample does not mean that the sampling error will decrease proportionally. The reason is that the sampling error is inversely proportional to the square root of the sample size.

For this research we adhered to the sample saturation point technique for interview part of our research, since the latter carries high explorative nature.

4.3. Data collection methods and procedures

In current study, different methods will be used to answer research questions which will allow to increase the validity of the results. This approach is known as triangulation in literature. The main advantages of triangulation approach include increasing confidence in research data, revealing exclusive findings, challenging or integrating theories, and providing a clearer understanding of the problem” (Thurmond, 2001, p. 254).

Therefore, we will use two research instruments to achieve research goal and to answer research questions: (1) Semi-structured interviews and (2) Online Survey.

The preliminary part of the research is presented in the form of semi-structured interviews, which will allow us to come up with relatively small but purposeful sample from interest sides including: Russian Microfinance Association's representatives, Self-Regulated organization's representatives and microfinance organizations' representatives.

Semi-structured interviews will allow us to get more insights about the industry and research problem and help to clarify the relevant aspects for the survey as well.

In this stage to obtain more rich-data information which will help us to partly answer research questions and to create more comprehensive survey. The executive level managers were targeted as potential interviewees. It is of high importance that selected respondents could provide the concrete personal examples or opinions about the issues existing in the industry and their personal point of view toward the more effective approaches to self-regulation of microfinance organizations in Russia.

The interviews will be taken both face-to-face and online (by skype). Specific semi-structured questions on the research problem will be asked to representatives of SRO MiR, RMC, based on the specific positioning of these institutions. Microfinance organizations' representatives will be asked about the field issues and their activities in form of more explorative semi-structured questions.

Table 2: Interview timetable

Name	Company	Position	Interview tool	First Interview date & time	Second Interview date & time
Yelena Strateva	SRO MiR, RMC	Director, Deputy director	By Skype	28.02.2018 12:00-12:45	17.03.2018 19:00-20:05
Andrey Paranich	SRO MiR	Deputy director	Face-to-Face	22.03.2018 17:00-17:50	
Andrey Kuznetsov	Profi Credit	Director	Face-to-Face	04.04.2018 11:00-12:30	
Pavel Sologub	Do Zarplati	Director	Face-to-Face	18.04.2018 13:00-14:00	
Alexandr Shustov	Money Fanny	Director	By Skype	18.04.2018 15:00-16:00	
Irina Khoroshko	MoneyMen	Director	By skype	19.04.2018 12:00-13:00	

We can characterize all conducted interviews as being in-depth and exhaustive. Although, there were some structured questions for all participants, however, these questions were formulated mostly to navigate the researchers, rather to hamper the flexibility and thoroughness of the interview.

Interview questions were structured in a way to obtain thorough understanding and examples of unethical practices existing in Russian microfinance industry. The questions were also directed to get participants' attitude and rational judgment toward the regulation of the industry, and how self-regulated organizations could develop more effective approaches to prevent the industry participants from unethical lending practices.

Actually, there are two target groups for interviews: representatives of self-regulated organizations in person of director and deputy director of SRO MiR, and microfinance organizations that are members of SRO MiR.

Semi-structured interviews with representatives of SRO MiR cover 5 main blocks of questions:

1. Questions related to the development and history of microfinance institutions in Russia,
2. Questions related to the creation and goal of such associations as RMC, NAUMIR and SROs in microfinance,
3. Questions related to how these institutions were trying to regulate the activities of microfinance institutions from 1990s and how they were preventing the unscrupulous practices existing in the industry,
4. Questions related to the achievements of SRO MiR implementing its goals and mission,
5. Questions related to how the government regulates the industry and how this regulation affects the sustainability of microfinance organizations.

Interviews with representatives of microfinance organizations cover 6 main blocks of questions:

1. Questions related to company's history, business model and strategy,
2. Questions related to how companies understand the ethics of the relationship with clients,
3. Questions related to the unethical behavior of participants that exist in the industry,
4. Questions related to how companies train and supervise their managers to avoid unethical behavior,

5. Questions related to whether SRO MiR implements its duties effectively and assists companies in conducting more responsible and ethical microlending,

6. Questions related to whether the regulation of the industry by Bank of Russia is beneficial for both MFOs and customers.

All interviews were recorded, and the transcripts were compiled based on detailed description of all parts of the interviews. Then, the transcripts constituted the data for the study. The saturation point was reached after sixth interview, when answers to the main questions started to repeat.

The second stage of data collection process is the creation and conduct of online questionnaire among the representatives of microfinance organizations. The survey will be distributed via e-mails or through direct contacting with the help of SRO MiR as an intermediary.

The target respondents for the survey was comprised to high level management including only directors, deputy directors and head of departments. The justification of such strict targeting strategy is the fact that questions included in the survey are mostly in the scope of high management responsibilities, and only people who are responsible for the governance of companies, could give responses to the questions asked in the questionnaire.

The questionnaire consists of 5 main blocks and includes both open-ended and closed-ended questions/

- The first block of questionnaire is demography part, which includes questions about the type, segment, credit portfolio size of the companies, and the positions of respondents as well,
- The second block includes questions regarding the determination of microloans' conditions and about ethical perceptions of interest rates by respondents. The block includes also questions about ethical evaluation of penalty types and sizes on overdue microloans, about extra expenses that MFIs charge aside the main loan amount and interest rate, and finally, questions on the average size of marginal indebtedness of customers in each company's portfolio.
- The third block comprises questions referring to the conditions of microloans by MFIs. In this block respondents are asked about all conditions and requirements that MFIs set on potential borrowers, in other words, this block includes questions such as the average approval rate of loans in each company, and how MFIs keep contact with their clients. There are also questions on the relevance of factors that might bring to unethical practices, on distinguishing the common types of unethical behavior demonstrations in the industry from service providers side, and how MFIs train and compensate their managers responsible for microlending to customers.
- The fourth block relates to the activities of SROs, and how effectively these associations implement their functions.

- The fifth block relates to the justification of the policy run by Bank of Russia toward the industry. In this block, very thorough and specific questions are asked to the respondents such as effectiveness of separate limitations regarding daily interest rates, marginal indebtedness, fines and marginal full cost of credits that the regulator impose on MFIs. There are questions that are directed to the evaluation of the attitude of MFIs toward policy of the regulator.

Overall, the questionnaire consists of 32 questions, 5 open-ended and 27 closed-ended questions. Almost all multiple questions offer variety of choices for each separate question that maximally covers the all viable options. From 27 closed-ended questions, 6 questions offer an open-text option to respondents, which will allow us to gather new ideas and insights about the concrete topics.

The final number of respondents is 40, from which 7 are from MFC, and 33 are from MCC. Such kind of distribution is a good representation of real relation between number of two types of microfinance organizations (as of 01.01.2018 there are 60 MFC and 2211 MCC).

Summary

As we have seen, the more appropriate research philosophy for the current research is pragmatism since the current research starts from the real problem and intends to find practical solutions. Regarding research approach, abductive was chosen as it allows us to maneuver from general theory of self-regulation to practical implication of the theory in microfinance industry and vice versa.

The stated research questions obviously show the explorative purpose of research design. Regarding the research design, multi-method qualitative study was.

For the research we have chosen purposeful sampling method, as the research problem requires to include in research process the participants from all interest parties. As subtype one of purposeful sampling method maximum variation was chosen that allows us to capture a wide range of perspectives relating to the research problem.

To achieve the research goal and to answer the research questions two main research instruments were chosen - semi-structured interviews and online survey.

Chapter 5. Data analysis and discussions

In this chapter we will analyze the data and make conclusions. Particularly, in section 5.1 the data gathered from in-depth interviews and online survey will be analyzed thoroughly and main findings will be stressed. In section, 5.2 we will discuss the main findings and give explicit answers to research questions. Then theoretical and managerial implications of current research will be stated in section 5.3. Finally, in section 5.4 the main limitations of current research will be discussed, and future research topics will be suggested.

5.1. Data processing and analysis

As noted above, two research tools (semi-structured interviews and online survey) were chosen for current study that will help us answer to research questions and make valid conclusions on research several topics related to research problem.

Interview analysis

As interview analysis generally refers to qualitative data analysis, we considered all appropriate data analysis techniques and chose ones that will allow us to analyze the data maximum effectively.

One of such technique is the use of computer packages, which is recommended mostly in case of high numbers of interview data (more than 40 interviews) (Adams et al., 2007). Since the data we collected during interviews in this research is not large in volumes, we will not use computer packages, rather will manage the data manually. The next widely used technique for interview data investigation is thematic analysis, which allow to categorize and quantify data with the aim of making more generable findings. However, as we do not have homogenous structure of respondents in our sample (some respondents represent SROs and RMC, while the others are representatives of MFOs), we will not use thematic analysis as well. Instead we will apply two traditional manual techniques to analyze the date extracted from transcripts of conducted interviews.

The first tool that will be used is “quote-research” technique, which means the use of quotes from interview as descriptive or approving examples (Folkestad, 2008). We will use this technique for presenting the main ideas of interviewees on current ethical issues and practices of MFOs, how MFOs understand ethics with clients, and how MFOs trains employees to ethical behavior and obedience to ethical standards. Also, quoting techniques will allow us to present and analyze the SROs and MFOs leaderships’ attitude and position toward self-regulation of the industry, and the

actions that SROs implement to prevent unethical behavior of participants. Finally, quoting technique will help us to analyze the opinions of interviewees toward the current regulation by Bank of Russia, after which we would analyze the potential for more effective self-regulation approaches for the industry. We will quote interviewees' as experts' opinions (expert A, expert B, etc.), in this way keeping the anonymous and impersonal interpretation of the results of interviews.

As the second technique we will use cross-interview analysis mainly for comparative purposes. This technique will help us to augment generalizability of the results. Particularly, we will use cross analysis to identify the main ethical issues present in current microfinance organizations that need regulation. Also, cross-checking of answers by interviewees will be used to come with more effective approaches to self-regulation of the industry extracted from the answers of interviewees. Additionally, this technique will be used to compare interviewees' opinions on different issues and concerns related both to the industry regulation and MFOs sustainability.

At the beginning of the interviews, the industry participants were asked to describe briefly their companies and entities they are working, the history and major development steps of their companies. The purpose of such questions was to get acquainted with the companies, and to have some general picture about segments, portfolio size, and organizational type of these organizations. As this kind of information carries highly descriptive nature, and high importance for our analysis, we will not discuss the answers of interviewees regarding their companies' overviews.

The next bundle of questions that were asked to experts and are of high importance for current research, relate to main ethical issues that present in microfinance industry, how participants understand ethics and implement in their business, what are the main ethical issues that require attention and regulation. We should state, that the answers of interviewees do not differ in most important topics.

As mentioned by one of the experts, ethical issues exist in microfinance industry from very beginning since 1990s and still exist: "Surely, ethical problems existed already that period when there was no regulation, moreover, this kind of practices exist even now but without regulation the number of such would have been higher" (expert A). Another expert states that during 1990s when the industry was just making first steps of development, and there was lack of experience, MFOs hired personal from banking sphere with the aim of boosting microlending, however such approach did not work: "the traditional banking financier was not applicable for this new business, as the customer base is different. Clients of banks differ greatly that's of MFO" (expert B). The same expert adds that one of the reasons for unethical practices of that period is that fact that that many non-professionals entered to the industry trying to earn good margins for short time. The

industry was very attractive for such people, who having some capital decided to invest in a field where the demand was extra high. But after the industry started to be organized and developed, these non-professionals faced huge problems: “interestingly, while the market was wild and not organized these people succeeded, but we can say that now this wave almost passed, and the regular regulation of the market force these people leave the industry. Very soon these non-professionals understand that the profit margin is not as high as they expected” (expert B).

Before asking experts about ethical issues that exist in the industry, we tried to get answers how they understand ethics with clients. It is very important to be sure that interviewees understand and have their perception of what is ethical behavior, what is morality, and how unethical behavior could harm clients.

Some experts stated that they have developed standards and principles in their companies that help them behave in more ethical manner in their interactions: “Long before the basic standards were issued, we had a very deep understanding of ethics in our relations with clients, we completely understand who our clients are, and our task is to help them make rational and deliberate decisions” (expert C). Another expert understands the ethics of MFO with its clients as a mutually beneficial deal: “The most important thing is that the interaction or deal between MFO and client should be mutually beneficial” (expert F).

The main unethical practices of early MFOs relate mostly to several major topics such as collection, high interest rates, high penalties and extra expenses for clients, lack of transparency on loan conditions, lack of training of personnel to ethical standards, using market power by MFO, irresponsible lending by MFOs etc.

1) Not surprising is the fact that the most discussed unethical practices that MFOs are abused for, are unscrupulous collection. All experts agree that the key issues from very 1990s were related to unethical behavior of MFOs or collection agencies toward clients, the circumstance that darkened the image of the whole industry both in media and minds of numbers of people: “Yes, in microfinance, the ethics mostly connected with the overdue loans and collection practices. The ethical issues were always subject of attention by all interest sides” (expert A). However, here we should mention that not all MFOs are collecting overdue loans by themselves. There are number of MFOs that outsource this service to collection agencies, and this circumstance makes difficult to understand that who is responsible for unethical practices that might be used to return the overdue loans – MFOs or collection companies? As expert B states “it is not clear who is darkening the image of the industry, since MFOs can collect the debt themselves or outsource it to collector companies. In most cases MFOs do not give small loans to collectors, as the latter are reluctant to take it due to lesser amounts”.

In current situation as well, all experts agree that collection still remains one of the problematic areas of the industry. As one of the experts noticed “many MFOs have special employees for overdue debts and collection, who sometimes collect payments in unethical manner and ways” (expert E). This means that not all MFOs solved this problem, regardless standards and other legislative and normative acts were enacted to regulate such behavior. Moreover, unethical and unscrupulous collection practices are taken place when anti-renting system of SROs exist and MFOs might be included in these lists.

The second ethical problem related MFOs activities is the issue of exploitative interest rates, that usually society define as “usury interest rates”. However, before making our judgments it is wise to listen how participants of the industry perceive this problem, whether they agree that the problem of high interest rates exist or not, and if exist to understand what the reasons and motivations of such behavior are.

What is important here, to take into account that interest rate is formed in a typical MFO from different components operational and maintenance expenses, allocations to reserves for overdue loans set by Bank of Russia, as well as cost of funding and profit margin that MFOs set to achieve. In contrast to banks, MFOs that lend microloans of small amounts for very short periods (for example 10,000-15,000 rubles for 15 days). This means the operational expenses are dramatically high. Also, reserve allocations are high due to high level of non-return in microfinance industry. Funding of MFOs is also high, and only MFC could admit deposits from private investors. “We should take into account, that with small loans the operational expenses are high enough, which increases overall cost of services, force companies to charge high interest rates to cover costs and have some minimum margin” (expert E). In contrast to banks, MFOs pay more for investment which also increase interest rate objectively. Another expert states the same idea giving more details: “The main reason is that expenses for paper, office, requests to credit bureau, personnel and other operational expenses are very high related to small amount of microloan. Additionally, the loans are given for very short period, and MFO should cover all these costs related to the very loan in the same short period” (expert B).

Regarding the comparisons of banking interest rates and ones that MFOs charge is of high interest for experts. Both brought the same example to show how this comparison is out of logic and how people perceive interest rates set by banks and MFOs: “I want to say that this comparison is not a wise decision. We can take the example of apartment and hotel. When you pay for rented apartment is analogous to banking rates, and the payment for hotel is analogous to MFOs’ interest rates. When you are renting a hotel for two days, and estimates the annual payment with this rate, it would be tremendously big amount. But in a short time, it is not critical, and you can afford yourself to pay this money” (expert C, expert D). Another expert also points out that interest rate

should cover expenses and future investments for company development, as well of some profit margin to provide its sustainability: “MFOs have costs and margin for profit and each of them decides what should be the size of margin, that will cover future investments and bring some profit” (expert E).

Talking about what is the ethical level of interest rate, experts have different opinions and some difficulties to point concrete figures. “I think 3% is the limit, higher interest rate than this level is unethical” expert F points out, while another expert mentions another level as being ethical: “I think that 1% is ethical, since in European countries this level is average, and Russian MFOs almost came to this level themselves” (expert E). According to another expert (D) 2-3% per day might be considered ethical. Here, again we should clarify that MFOs that operate only in PDL segment, consider 1,5% and more interest rate as ethical, while MFOs that operate in installment loans segment, can afford to charge lower interest rates. Therefore, experts’ judgments toward ethical level of interest rate are a little bit ambiguous, and we cannot figure out concrete level from interview data.

Another problem that MFOs are accused for is high penalties and extra expenses they charge from clients. Experts agree that current regulation mostly solved this issue, and Bank of Russia set the maximum size of the penalties MFOs could charge. However, even today some MFOs have such practices: “We have another interesting moment, before current regulation, when a client might forget to repay its loan, some MFOs taking advantage of this situation do not inform clients before the loan turns to overdue and later charge extra high fines. A loan of 10,000 rubles is very soon becomes 150,000 rubles due to 5% fine on overdue loan. Interestingly, from the court perspective, it’s normal as there is a contract and MFO are right to charge penalties” (expert B). Another expert also states that such practices reached to minimum under current regulation: “In the past, there were such practices in the industry, when MFOs drove clients to debt funnel and then charged extra excessive amounts in comparison what they borrowed” (expert E). The same expert goes further and shares with another value observation “such schemes are not possible for MFOs operating in legal market, but it is beneficial for “grey” participants who wants that clients go default in order they could charge more money from”. Regarding fines and accumulation of huge debt for overdue loans, expert C thinks that one of the main reasons why PDL segment is more vulnerable for unethical practices is accumulation of huge fines and penalties: “I can just state my opinion that this negative attitude toward PDL segment comes from the fact of endless increase of the debt” (experts C). Finally, one of the experts just state that completely agree with current regulation on fine accumulation: “I don’t think that now there are high fines, it is regulated in proper way and these concerns related only to the past” (expert D).

One of the most common ethical issues is lack of transparency on loan conditions, which some MFOs could demonstrate in their interaction with clients. Moreover, lack of transparency might not only be demonstrated in disclosure of full information, but also not referring clients options of prolongations and restructuring: “One of the main ethical issues that might be seen in some cases is the hidden information about loan conditions, size of penalties for overdue loans, extra payments such as insurance, . The problem is that MFOs inform about these payments, but not consult clients about loan conditions. What is important, that MFO should help clients in case of difficulties and offer options that will help them to manage with the situations” (expert D). Another expert thinks that the problem of transparency and lack of full information on loan conditions are issues not only for MFOs but also for banks’ clients: “Transparency on conditions, but maybe this problem exists not only in MFOs but banks as well” (expert F).

Analyzing responses of experts regarding main ethical issues and unscrupulous practices, we should pay attention to one important indicator, which MFOs brought as a justification that they highly value their clients and each client is very important for their company. This indicator is client return rate, which is high in all companies our interviewees represent: “We are highly motivated to serve client with high quality in order to make him come back to our office. The return rate is very high in our company, more than 70%” (expert D). Another expert also mentions about high return rate as a good indicator for client valuation: “Return rate of clients is very high (more than 80%), which shows how we value every client” (expert E).

2) Next important topic discussed with all interviewees relates to potential reasons of unethical behavior and the motivations that bring to unethical practices in the industry.

Although answers of experts differ, but one common pattern can be distinguished in all answers. The main reason of unethical behavior or unscrupulous practices takes its roots in people’s education and moral perception about good and bad. Saying people, we first refer to owners and heads of the company, and also ordinary employees. People who lack morality, family education can behave unethically: “Such people are very jealous and want to gain maximum from the market, from each client” (expert D). Another expert also states the same idea “Why some people are arrogant, while the others are ethical and conscientious? Because the latter like their job, want to do it well, and leave some track after their life. But there are people who are eager to exploit others and earn maximum from given chance” (expert E).

Another reason that is supposed to bring unethical practices is lack of competition, when clients do not have ability to make comparisons, agree to the conditions offered by MFOs. Sometimes, MFOs could take advantage of this situation, and charge high interest rates or do not offer loan prolongations and restructuring to clients, which is not honest toward people that are in dire situation due to some objective or subjective reasons: “Especially in many regions, if there

are few alternatives or not at all, clients have no choice and cannot choose MFO with lower interest rates or make comparisons” (expert B). However, other experts are suspicious little bit about this thesis, and think that the competition is high in the industry: “Nobody wants to increase interest rates taking advantage from this situation. The opposite is true, interest rates always tend to go down. A few years ago, interest rates started to decrease from 3% to gradually to current level of 2 %” (expert D). Another expert believes that competition is high, but it depends who is the client as there are frauders and responsible ones: “Actually, there are two types of clients. Ones that take money and they know that are not going to return the debt, because they are unethical, irresponsible and for these clients it does not matter where to take, they don’t need comparisons, and from the other side, there are clients that are conscientious people, and they are ready to pay their loans, even though sometimes they might be in dire situations” (expert E).

Irresponsible lending my MFOs might be another reason for unethical practices. Regardless, existing common opinion that MFOs are lending everyone, experts critically disagree with this statement: “The common opinion, that MFO lend money to everyone, and then collect with unfair ways, is absolutely incorrect. Maybe such kind of practices are not exclusion and were common in the past. Nobody wants borrowers that could not return loans” (expert A). Another expert goes further and explains that in current situation when the regulator controls MFOs’ activities and with various measures tries to protect clients, it is not rational to lend people who cannot return loans: “What is interesting, that there is no logic for MFO to lend money to everyone when there are limitations for interest rate and fines. Yes, we can propose that with the absence of limitations MFO could lend to everyone without looking whether clients are adequate or not, and later charge extra at least some part of these high interest rates and fines through courts. However, when there are limitations, it is not beneficial for MFO to lend everyone without thorough evaluation the creditworthiness of a client (expert B)

3) Another important topic in the context of ethics is training of managers, how MFOs train their employees to moral and ethical standards and values. As managers, agents, and other employees are directly responsible for interaction with clients, selection of appropriate people to work is very important. Not surprisingly, all experts state that they have well developed steps for employees’ training. “First of all, managers are trained what is good and what is bad, how they should behave in their interactions with clients. Also, they should possess complete information about our product, payments and other conditions of loans” (expert C). Another expert also confirmed that they give high importance to the process of future managers training in various steps: “Basically, we control managers that are responsible for lending. We have also call center, hot line, and optionally we call some clients to get feedback about the quality of service they got from managers” (expert D).

All experts state that training of managers is firstly directed to the full possessing of all necessary information on loans and lending conditions, but employees are motivated for self-education and leadership talents development as well. MFOs also check managers moral values, which kind of problems they might have, and psychology as well: “First, we choose ethical people, look their psychology, how they behave. After we test stress steadiness. Also, the atmosphere is different in our company, we have very calm working environment. There is no aggression and we exclude people that like to use power (expert E).

As we can see, MFOs are more motivated to filter and hire more responsible, balanced, and ethical people to work in their companies, which is accompanied with regular trainings, transfer of core values of the company to new employees and controlling: “We completely control the quality of our employees. The department for audio control now consists of almost 60 people, 3 couches, and they all are engaged only in controlling managers’ interaction with clients” (expert F).

4) Next topic discussed with interviewees relates to the regulation of the industry by Bank of Russia. The main attention was directed to the measures and limitations Bank of Russia set during the last few years as well as ones that it is going to impose in near future. Also, with interviewees were discussed issues that the state regulation solves by imposing specific limitations, factors that might harm the sustainability of the industry and experts’ opinions toward the regulation by Bank of Russia as mega-regulator.

The main insight that was the opposite of our expectations, is that experts show sympathy toward the policy that Bank of Russia has implementing in the industry and believe that it was necessary. All experts that represent MFOs, regardless their subjective opinions on distinct regulation tools and measures, agree that the regulation by Bank of Russia mostly solves the problems it supposed to manage with various limitations as well as helps to rise the image of the industry.

One of the expert states, that MFOs are business units and their main goal is to earn maximum profit, and regulation is needed to set limits on this desire and prevent customers from unscrupulous behavior of MFOs: “every business unit is concerned to earn maximum profit, it is the nature of any business no matter the industry. Other thing is how businesses will earn their profit and in which ways, And here, the need of regulation increases. If we compare the norms of behavior it is the duty of the police to control and to protect the citizens, while in financial market in place of police it becomes Bank of Russia that should regulate the market” (expert C). Another expert goes further and shows why policy of Bank of Russia is mostly beneficial for the industry: “Regarding the limitations on daily interest rate, overall indebtedness, penalties, I can say that till now these measures are in scope of rationality and right. These measures are not harming the

economy of MFOs yet, rather help you to stay in a tone, motivate business processes, to think when and where you can cut your costs more efficiently” (expert D). One of the main limitations Bank of Russia is setting is the maximum size of interest rate, the measure that prevent unscrupulous MFOs charging exploitative interest rates: “The measure of interest rate, for example, is a good tool both for MFO and the Regulator to control the interest rate, and prevent MFOs from charging different rate 5%, 3%, 2%. Also, this measure prevents some greedy MFOs to charge exploitative rates” (expert F)

In February of current year during the yearly conference of “FinFin”⁴⁰, Bank of Russia presented its new suggestions regarding the main limitations that exist for MFOs. These limitations comprise such measures as maximum size of daily interest rate (up to 1% from 2019), marginal indebtedness of a client (rule of 3x, 2x, 1,5x etc.), overall amount of debt (rule of 3x, 2x, etc.).

The experts think that these requirements and limitations Bank of Russia is imposing on participants might be non-effective and even harm both MFOs as well as clients as end users. As one of experts points out: “When Bank of Russia sets extra limitations and various requirements on MFOs, it indirectly increases interest rate that MFOs charge from customers. To put these expenses in figures, we can say that in 2017 Bank of Russia costed MFOs 0,3-0,5% increase in per day interest rate, which means that the cost of credit is increasing correspondingly” (expert B). Another expert also agrees that the regulation and measures should be rational and do not harm MFOs and the industry: “We can say that overall, the limitations of Bank of Russia are justified, and till now these limitations are rational, since the regulation gives right order and image to the industry, the thing is the size of the regulation” (expert D). The third expert believes that setting of stricter limitations is not justified in very short term, since MFOs could have time to respond these changes: “Setting 1% a day interest rate is a very cardinal change in very short time, which requires change in economy and business processes by MFOs” (expert F). The same expert continues: “We can conclude, that such a policy is not good for final customer. These measures are supposed to be for clients’ protection and rise of financial inclusion, but at the end they might harm lots of scrupulous people who will be taken final chance of solving some problems of their lives” (expert F). Finally, the third expert states that “If Bank of Russia has not set these limitations, interest rates would have even gone down”.

Hence, we can see from the answers that such a policy with radical measures might harm companies and force them to go illegal.

Regarding the reasons and the motives that force Bank of Russian to impose stricter limitations on MFOs, the experts also have common opinions. First common pattern in their views

⁴⁰ <http://finfin.rmcenter.ru/#about>

is that the experts are not completely grasp the rationale behind this policy: “Honestly, it is difficult for me to judge about the effectiveness of such policy” (expert C). In addition, the experts think that such strict regulation might be result of political pressure. The debates on so called “usury interest rates” are topic of debate among politicians for many years, and many deputies of the parliament criticize harshly MFOs. This is one of the reasons that the political pressure might work through Bank of Russia’ limitations: “I think it is a result of political pressure regarding the size of the interest rate, mostly a negative reaction from deputies, the customer protection society, who hardly grasp how economics works. When such politicians hear high interest rates like 700-800%, they think that MFOs just put the difference between interest rate and cost of funding into their pockets, but it’s not true” (expert B). Another expert also believes that political pressure is the main reason for such kind of regulation: “Why Bank of Russia is doing it, I think it is mostly result of political pressures. The government forced to do more actions and to invent something that’s why Bank of Russian should think and implement new limitations or offer new products” (expert E).

5) The final major topic for interviews relates to SROs. The main questions asked to interviewees had the purpose to understand how SRO could effectively implement its functions, whether it is possible for SROs to self-regulate the industry, and also figure out MFOs’ representatives attitude toward SROs.

The experts from SRO indicate in all their answers that SRO is doing everything to prevent MFOs from unethical behavior as well as protecting both MFOs’ and clients’ interests. As one of the experts mentioned: “SRO from very beginning started the process of preventing unscrupulous practices of the industry via standardization and enforcement mechanism” (expert B).

However, the experts from MFOs are not confident that SROs are implementing their duties efficiently. Moreover, some of them don’t see any real value of SRO. But we should state that all experts have common opinion that so called “golden balance” is preferable and useful both for MFOs and clients: “Theoretically, SROs could regulate the industry, but with the same instruments as used Bank of Russia. Why it hasn’t done, because it is evolutionary process and SROs cannot change it immediately in one two years. I am sure, that Bank of Russia demonstrates quite balanced, objective and open approach” (expert C). Another expert also is also suspicious that SROs could self-regulate the industry: “In theory it might work. I know that many lawyers make suggestions to Bank of Russian regarding different issues of the industry. More important is the balance that SROs and Bank of Russia should keep between the interest of business and interest of customers” (expert D).

Interestingly, some experts indicated not only that SROs and Bank of Russia represent different interests, but also gave some insights why MFOs and SROs could not self-regulate the

industry as effective as it is doing Bank of Russia: “Maybe SROs could regulate the industry, but we should admit that SRO is a corporate institution, while Bank of Russia is a State representative. Also, in our country people like orders and regulations from state, and only in this case they obey the rules of the game” (expert E). Another expert believes that the effective regulation of the industry is in balance of these two institutions: “I think, that there should be balance and symbiosis between these two bodies, which have different interests. Surely, some overlapping exists but SRO represents the industry and always will protect the interest of participants, while Central Bank represents the state and citizens” (expert F).

Regarding the question whether SROs help participants in the scope of their functions, the experts have different opinions. There are ones that think that SRO is doing many things directed to the development of the industry: “SROs develop different methodologies for the interaction of MFOs and the regulator, also SROs have number of functions such as assistance of MFOs opening, helping MFOs to contact potential investors, etc.” (expert E). The others think that SROs are not as effective in their actions as they could. “I can’t say that SRO is effective, but I see that they want to do something. I didn’t hear that SRO brought any legislation regarding the industry. Surely, SRO should protect the industry, otherwise why we need it. SRO also issued standards, but it doesn’t work. It remained on the paper, since most of the companies reach to this themselves and don’t need it” states expert D in his answers.

Generally, we can see that MFOs’ representatives do not see that SROs could self-regulate the industry via standards, rules of conduct, and think that only balance between functions of SROs and that’s of State, is the more optimal option to regulate the industry.

Survey analysis

As already mentioned, online survey was created to get answers on research questions from MFOs to validate and generalize the findings from interviews as well as get new insights from respondents. The questionnaire comprises both open-ended and closed-ended questions and includes questions regarding main topics discussed in interviews. Moreover, in questionnaire majority closed-ended questions were constructed in a way that respondents were offered diverse options that they can choose. This was made to eliminate the problem of response time which is one of the main drawbacks of open-ended questions. For analysis of survey results, will be used both tool of thematic analysis for open-ended questions and mean estimations for 5 points Likert scale questions (for example M=3 is an average, and M=3.5, for example, indicates that the respondent evaluates certain characteristic, factor or issue as being high, important, positive or significant).

As we can see below in figure 4.4, from 40 respondents, 33 were from microcredit companies, and 7 from microfinance companies. Regarding the portfolio size, 30 respondents were from small, 6 from medium, and 4 from large MFOs.

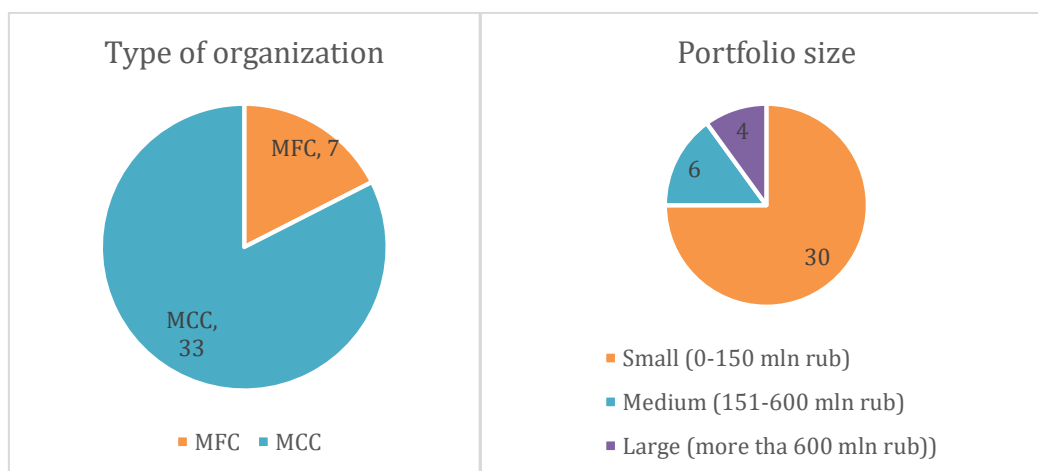


Figure 4: Organizational type and portfolio size of MFOs

As the target for survey was comprised to only high-level management, the distribution of respondents according to their position in their companies was the following: 29 people were directors of MFO, 7 were deputy directors of MFO, and 4 were heads of departments.

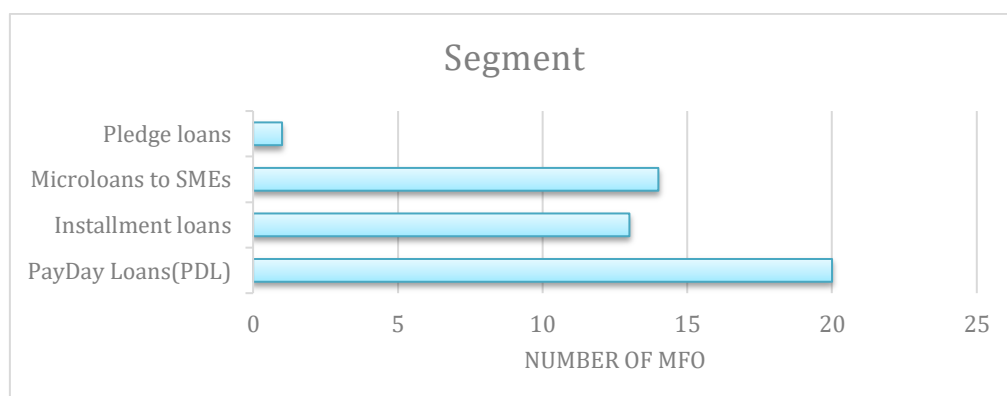


Figure 5: Distribution of companies according to the segment

From 40 respondents only 7 stated that their companies are engaged in more than one segment. As we can see from figure 4.4, twenty companies are operating in PDL segment, thirteen in Installment loans segment and fourteen in Loans to SMEs.

The first part of the survey includes questions related to the formation of interest rate in companies as well as well as questions to check how respondents understand the ethics in their decisions regarding interest rates, extra payments and usage of penalties.

The respondents were asked to specify the share of main components that form interest rate for the most popular microloan of their companies. This statistic is important to make judgment about rationality and morality of charged interest rates by MFOs. The mean estimations

show that the highest share have such components as expenses of personnel (almost 25%), reserve deductions (23%), operational expenses (almost 21%).

Table 3: Average share of main components in total cost of a popular loan

Components (expenses, profit margin)	Average share
Funding expenses	15,25%
Reserve deductions for overdue loans	23,25%
Operational expenses	20,75%
Personnel expenses	24,50%
Expenses for collection of overdue debt	15,25%
Profit Margin	15,50%

Regarding the problem of high interest rates, respondents were asked to evaluate the level of interest rate from ethical perspective. The purpose of such question was to grasp how participants of the industry perceive level of morality relating to pricing decisions. The pre-assumption was that depending on the segment, respondents' answers about the ethical level of interest rate should vary from low to high. This expectation comes from the fact that in different segments, interest rates differ dramatically due to terms of the loans, business model and business processes of MFOs, as well as due to many other reasons.

For instance, from MFOs that are operating mostly in PDL segment, we expected respondents to indicate high interest levels to be ethical, since costs are high in this segment and loans are issued for short terms. In contrast, we expected that respondents of MFOs that are mostly engaged in Installment loans and SME loans segments, would specify quite low interest rates to be ethical.

The results proved that such expectations were rational and respondents' answers about ethical level of interest rate showed that these levels were proportional to which segment MFOs operate in.

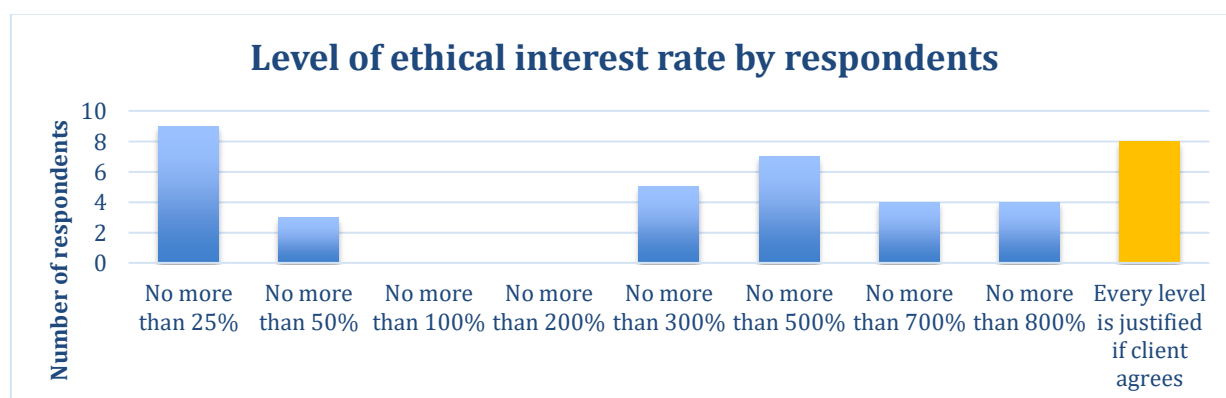


Figure 6: Level of ethical annual interest rates by respondents

As we can see from the diagram, 9 respondents mentioned that maximum 25% annual is an ethical level. All these respondents are from companies that operate in installment loans and SME loans segments. In contrast, respondents that are from MFOs operating in PDL segment selected as ethical interest rate level ones that are more than 300% annual.

What is interesting, eight respondents believe that every level of interest rate is ethical when client agrees. Moreover, these respondents are from all segments, which allow us to think that there are number of MFOs in the industry that are inclined to set maximum interest rates that the current legislation allows. However, we know that under imperfect competition many clients might agree to borrow microloans not making rational choices and comparisons, which means that from moral perspective MFOs that set high interest rates are not behaving ethically with clients.

Respondents were also asked about fines and penalties that clients should be charged for overdue loans. Sixteen respondents indicated that every violation of the contract must be punished by fines, and twenty-four respondents believes that clients should be punished by extra fines only if MFOs carry extra expenses for overdue loans. This statistic allows us to think that 40% of respondents are inclined to charge fines on clients without considering that these clients might be responsible and scrupulous people, who face some temporary difficulties in their lives and cannot repay the loan due to objective reasons.

Regarding abuses that MFOs usually charge extra payments from clients, the respondents were asked to specify whether they have extra payments and expenses that are obligatory for getting loans. The results show that the majority (24 MFOs) don't have any additional payments for clients aside loan amount and interest rate. The most common additional expenses that remaining 16 MFOs require from their clients are mandatory insurance costs, payment for prolongation and restructuring of the loans, as well as payment for assessment of property.

The next topic related to the abuses that some MFOs are irresponsible and lend people who are unable to serve their loans and repay the debt according to schedules. In this context, the respondents were asked to specify what are the requirements that their companies demand from clients to get microloans.

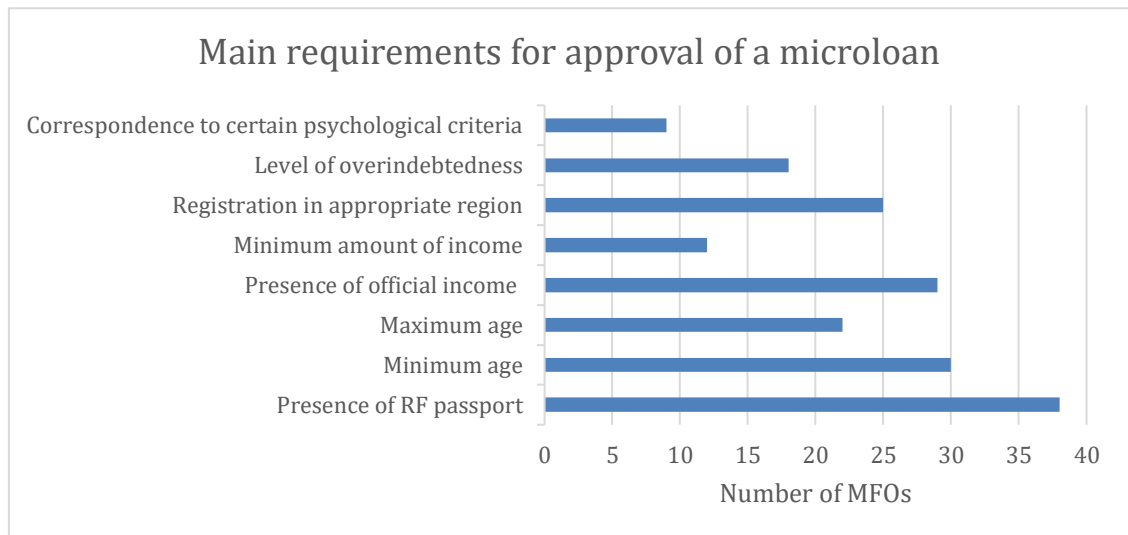


Figure 7: Main requirements for approval of a microloan

As we can see from figure 4.6, among requirements that are necessary for clients to get a microloan, age, official income and registration are most common. However, such requirements such as correspondence of clients to certain psychological criteria and level of indebtedness of clients are mandatory in less than half of MFOs. Even though it is always difficult for managers to recognize all psychological characteristics of a potential client without special tools, however some MFOs are stubborn to check level of adequacy and accountability of clients. Particularly, only nine respondents stated that their companies require clients to correspond to some basic psychological criteria. Another requirement is the level of indebtedness of clients, and we can see from figure 4.6, that this indicator is mandatory for less than half of MFOs. Overall indebtedness of clients is one of the major problems of the industry, and very often MFOs are accused for pushing clients to the debt funnel. Moreover, as the problem of high indebtedness is one of the ethical issues related to the industry, the regulator imposed special limitations on it.

Going further with the problem of irresponsible lending practices by MFOs, the respondents were asked to specify the approval rate of credits in their companies. The survey results showed that in 27 MFOs approval rate is more than 50%, while only in 13 MFOs this rate is less than 50%. Moreover, 19 from 27 MFOs have approval rate higher than 70%. These figures allow us to think that irresponsible lending concerns might exist in the industry and especially in companies that have approval rate more than 70%.

Another important topic related to unethical practices that exist in the industry is the training of managers to ethical standard and moral values. To figure out how MFOs train their employees to ethics and more responsible lending, the respondents were asked to indicate the main methods their companies use to train employees.



Figure 8: Training and control of employees' ethical behavior

We can see above that MFOs implement various methods to train and control personnel to more ethical standards. The most common means are control of managers interaction with clients, hot line for complaints, and mandatory training of employees to ethical standards of companies and SROs.

One of the most important part of the survey is devoted to the most common ethical issues that exist in the industry. All major issues and practices that were distinguished after literature review, foreign countries experience analysis and interviews, help us to create a group of 11 most common ethical problems and practices that MFOs might have. Based on this list, the respondents were asked to specify the relevance of each issue in the industry.

Table 4: Relevance of most common ethical issues in the industry

Relevance of issues related to unethical behavior of MFOs	Average share in total number of MFOs
Exploitative high interest rates	47%
Lack of transparency on loan conditions	38%
Not clear explanation of loan conditions to a client	36%
Lending to clients with low creditworthiness	38%
Unscrupulous collection practices	39%
Disobedience to SROs' standards	34%
Absence of option for loan prepayment	31%
Absence of loan restructuring options	33%
Not informing clients in upcoming payments	35%
Illegal penalties on overdue loans	33%
Aggressive marketing	43%

However, we should state that the expected bias from this question was quite high due to the fact that the industry participants were asked to evaluate relevance of unethical behavior that might refer to their companies as well. As we can see, all issues described in the table above got less than 50% relevance, and it supposed from these figures that there are not relevant ethical issues in the industry, which is probably not the case. For this purpose, we would interpret the results from table 4.3 not as disruptive of real figures based on mean estimations, but rather from comparative and ranking perspective. Hence, as we can see from the table 4.3, the most relevant ethical issues in the industry relate to high interest rates, unscrupulous collection practices, lack of transparency, irresponsible lending practices by MFOs, not clear explanation of loan conditions to clients and aggressive marketing policies.

The following step was to figure out what are the most common reasons that MFOs could practice unethical behavior with clients. Again, the main reasons that were figured out from literature review and interview data, were grouped, and the respondents were asked to specify the significance of these factors.

Table 5: Significance of factors that could bring to unethical practices if MFOs

Factors that could bring to unethical behavior of MFOs	Significance
High competition, fast growth and fight market share	-
Pressure of investors to demonstrate high grow indexes	-
Absence of regular training personnel	+
Ineffective compensation system of managers	+
Low financial literacy of population	+
Absence of alternatives for low-income people to get loans	+
Absence of competition in many regions	-

The significance was estimated using the average of 5 points Likert scale, and all factors were evaluated according to the percentage respondents gave for each factor. The factors that received less than 50%, are not significant, and factors that got 50% and more are considered to be significant. As we can see, absence of training personnel, ineffective compensation system, low financial literacy of population and absence of alternatives are factors that are significant, and could bring to unethical behavior of MFOs.

The respondents were also asked to specify the most effective ways how to improve the behavior of such MFOs that behave unethically. According to the answers, the most effective methods are: (1) ranking system with explicit publications, (2) mandatory training of managers to

ethical standards, (3) Regular revisions using tool of “hidden customer”, (4) penalties and deprivation of licenses.

The next block of questions of the survey relates to SROs. Particularly, the respondents were asked to evaluate the effectiveness of SRO implementing its functions. As a basis, main functions SRO MiR were chosen to create the list of main ones, which were cross-checked with the functions of other two SROs (Edinstvo and Alians), and only after final list was created.

Table 6: How effectively SRO implement its main functions

Functions of SROs	Effectiveness
Assistance to increase legal literacy of population	High
Assistance to increase financial literacy of population	Medium
Fight against “grey” market	Medium
Responding to costumers complaints and protecting their rights	Medium
Assistance to increase of transparency by MFOs	High
Assistance MFOs in finding financing	Low
Development of ethical standards of conduct for MFOs	Medium
Participation in creation of legislation that represents rights of MFOs	High
Regular checkups to prevent unethical practices of MFOs	Medium
Assistance to MFOs with training of managers to ethical standards	High

Again, with the results from the question how effectively SROs implement their functions, we expected high bias by MFOs regarding the evaluation of SROs functions. The question was created with 5 points Likert scale, and the results, based on mean estimations, showed that only one function (assistance to MFOs find funding) is implemented not effectively. According to the respondent’s evaluation, all other functions SROs are implementing effectively.

To reduce this bias, we will interpret the results from comparative and ranking perspective. Particularly, from table 4.6 we can see that MFOs evaluate the effectiveness of implementation of SROs’ functions dividing into low, medium, high. This allows us to get extra information in which aspects SROs are less effective and in which are more effective. This information is important for making our suggestions regarding approaches to self-regulation of the industry.

Finally, the respondents were asked about different limitations and measures Bank of Russia have imposed as well as one that is going to set. Overall, the attitude toward the Policy Bank of Russia running regarding the regulation of the industry is from negative- to-neutral, however the respondents have more critical opinions regarding separate measures Bank of Russia want to impose.

Table 7: MFOs representatives' attitude toward measures by Bank of Russia

Measures	Is a consequence of unethical behavior of creditors	Will decrease unethical behavior of creditors
Unified limitation of the borrower's debt limit (2.5x, 2x, 1.5x)	No (M=2.3)	No (M=2.7)
Limitation of the daily interest rate of 1.5% (from 01.07.2019 1% per day)	No (M=2.6)	No (M=2.5)
Limitation of the full cost of consumer loan (FCC)	No (M=2.9)	No (M=2.8)
Limit on the amount of the penalty (not more than 20% per annum or 0.1% per day)	Yes (M=3.2)	Yes (M=3.1)

The respondents were asked to show their attitude toward several statements regarding the measures Bank of Russia imposed. Again, 5-point Likert scale was used, where average is M=3. As we can see from the table above, the respondents do not think that the limitations by Bank of Russia already imposed and ones that is going to set in near future are consequences of unethical behavior of some MFOs. Nor they think that these limitations will prevent MFOs from unethical practices. An exception is a limitation on penalties that might be considered by respondents as a consequence for unethical behavior of MFOs and as a tool that will prevent such behavior.

Then the respondents were asked to evaluate the influence of measures Bank of Russia set on MFOs' sustainability by 5-point Likert scale (average is M=3).

Table 8: The influence of measures on MFOs' sustainability

Types of Measures	Influence on MFOs' sustainability
Unified limitation of the borrower's debt limit (2.5x, 2x, 1.5x)	Negative (M=2.3)
Limitation of the daily interest rate of 1.5% (from 01.07.2019 1% per day)	Negative (M=2.45)
Limitation of the full cost of consumer loan (FCC)	Negative (M=2.7)
Limit on the amount of the penalty (not more than 20% per annum or 0.1% per day)	Negative (M=2.95)

As we can see from the table above, the respondents believe that new limitations will harm sustainability of MFOs.

5.2. Discussion of empirical findings and explicit answers to research questions

The research goal of current study was to explore the possibility of developing self-regulation approaches for microfinance organizations. To reach the goal two research questions were stated.

The first research question is:

1. What are the most relevant ethical issues of Russian microfinance organizations which may require regulation?

To answer this research question, the relevant literature was reviewed. The review revealed that the most common ethical issues existing in microfinance industry are: lack of competition at least in some regions and cities, high interest rates, lack of transparency, irresponsible lending by MFOs, overall indebtedness of borrowers, low level of financial literacy.

Next step was to study both foreign and Russian experience of regulation of the industry by using secondary data, which was aimed to find out what are the most common types of unethical practices of the industry that need regulation. The results showed that the range of most common unethical practices by MFOs that exist both in foreign countries and in Russia, include problems such as high interest rates, unscrupulous lending practices, lack of transparency in interaction with clients, irresponsible lending by MFOs, non-obedience to SROs standards, lack of flexibility by MFOs regarding options of loan prolongation and restructuring, illegal penalties on overdue loans, not informing clients about upcoming payments, and aggressive marketing.

All these problems and practices of unethical behavior were used as a basis for discussion during the interviews. According to answers received from industry participants, some of these issues that require regulation, were confirmed to exist in current industry, while the others turned out to be not relevant. After analysis of interview results, we can state that the most common ethical issues of MFOs are remaining **unscrupulous lending practices, high interest rates, lack of transparency on loan conditions, lack of flexibility by MFOs.**

Then, the aforementioned issues were grouped and asked to MFOs, which evaluated the relevance of each in the industry. According to the results, the main unethical issues that still exist and need regulation are: **(1) unscrupulous lending practices, (2) high interest rates, (3) lack of transparency, (4) irresponsible lending by MFOs, (5) aggressive marketing**

Among the reasons that could bring to unethical behavior of MFOs, as survey results showed, the following are most significant – absence of regular training of personnel, ineffective compensation system of managers, low financial literacy of population and absence of alternatives for low-income people to get loans.

The second research question is:

RQ2 – What should be an effective approach to self-regulation of the industry to prevent unethical behavior of MFOs?

To answer this question first the theoretical concept of self-regulation of the industry was studied, then the experience of self-regulation in microfinance in foreign countries was reviewed, which allowed us to get necessary information to conduct interviews with representatives of MFOs and to create survey as well.

We should state that the initial pre-assumption regarding the most effective approach to self-regulation was one with maximal role of SROs and minimal role of state in the process of regulation of the industry. We were inclined to think that in high competitive market state regulation might be very harmful and self-regulation might be most effective approach to the industry. However, the results from both interviews and surveys proved that this approach might not be effective and workable to apply to Russian microfinance industry due to several reasons:

1. SROs are not perceived by MFOs as institutions that could regulate the industry setting appropriate limitation and measure that will prevent unethical behavior of participants,
2. Regardless there are some overlapping functions of SROs and ones of the regulator, however, SROs are perceived by participants as a commercial body, which represent the interest of the industry, while Bank of Russia mostly represent and protect interests of customers.
3. SROs do not use properly the enforcement and punishment mechanisms they have to prevent MFOs from unethical practices and disobedience to ethical standards,
4. Low sense of unity among participants of the industry – MFOs don't act with combined efforts and don't have unified policy toward the development of the industry (free riding problem)
5. Country specific - Russians are law-abiding citizens under centralized state regulation, the level of self-discipline and self-regulation is low for Russian business entities,
6. SRO might regulate the industry; however, the tools would be more or less the same as Bank of Russia is using,
7. State intervention to the industry is justified by the fact that the industry is growing dramatically (with 30-40% annual growth) and is not stable for self-regulation.

Therefore, the most effective approach to self-regulation of the industry becomes so called **“balanced” approach**, which implies symbiosis between SROs' and the regulator' functions and responsibilities directed to the regulation of the industry.

Both interview and survey results showed that the balance of the regulation between SROs and Bank of Russia is, perhaps, the most effective approach. From interviews we have that all

MFOs representatives are suspicious that SROs could self-regulate the industry, rather they think that SROs and Bank of Russia represent interests of different groups, and only balance approach would be the most effective which will allow to protect interests of both clients and MFOs.

According to the results from survey, from 40 respondents, 37 stated that for the regulation of the microcredit industry there should be a competent joint work of SROs and Bank of Russia. And only 3 respondents believe that SROs are able to self-regulate the industry without state intervention.

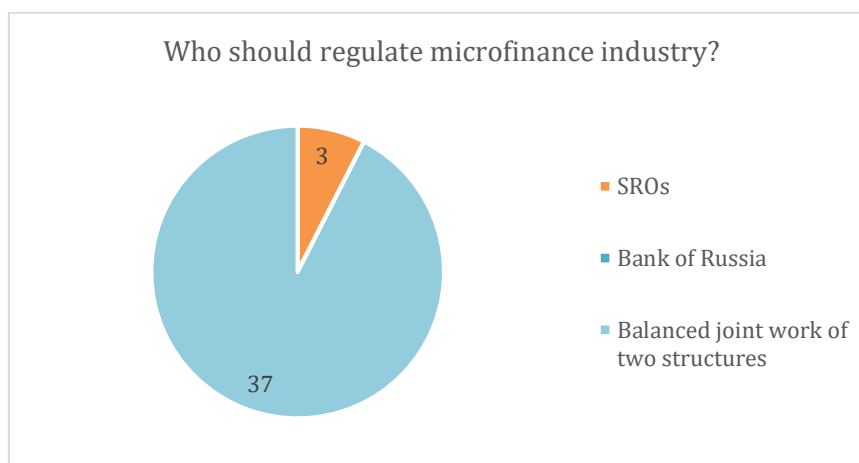


Figure 9: Bodies that should regulate microfinance industry

In current situation, SROs role is quite low, and there are several important steps toward the improvement of self-regulation of the industry that SROs should implement:

1. Assistance to develop a public position with strong commitment to ethical values of SRO and communicate this position to all relevant stakeholders,
2. Develop a platform for the interaction of MFOs with the regulator, which will allow participants to represent their ideas and concerns before any kind of limitations and measures are issued,
3. Develop more effective enforcement and punishment mechanisms that will increase obedience of MFOs to standards of SRO,
4. Assistance in introducing the concept of good and bad performance of MFO. Stop defending “the whole market” and defend only good members and blame bad members,
5. Assistance to develop a method of systematic evaluation of ethical performance (audit, surveys, mystery shopping, complaints, etc.) and publishing its results
6. Develop a system of ethical training for MFOs’ managers which may be used at low cost by SRO members
7. Develop recommendations and guidelines about increasing efficiency of MFOs which may allow to reduce interest rates and public pressure on MFOs

8. Develop industry-wide mechanisms that may help to cut costs and reduce interest rates (e.g. common big-data solutions for scoring, etc.).

Aside main findings, the current research also provided some other important findings and insights:

1. Unjustified non-benevolent attitude exists toward the whole industry
2. Generally, MFOs think that ethical issues are not relevant in current microfinance industry – the reasons might be the following:
 - *MFOs do not grasp ethical nature of issues existing in the industry*
 - *MFOs understand but do not admit that ethical issues exist in the industry*
 - *In reality, MFOs think that currently the level of ethical issues is minimum in the industry*
3. Unscrupulous behavior of many clients (irresponsible borrowers, swindlers)
4. Political pressure could decrease the sustainability of MFOs through Central Bank strict regulation
5. High concentration of the industry – only 60 MFC possess 80% of total profit of the industry,
6. Loopholes of current legislation regarding the operations of so called “Black” creditors,
7. Absence of well-established legislation referring to borrowers that will compel clients to return taken loans,
8. The policy by Bank of Russia is directed to the transformation of microfinance activities to social business, but the government do not offer any incentives and support to MFOs,
9. Limitations by Bank of Russia will indirectly harm the final users (customers) - high interest rates if possible, extra fees, few people can get microloans.

5.3. Theoretical and managerial implications

This research paper is dedicated to the identifications of ethical issues and unscrupulous practices that exist in microfinance industry, as well as to the search of most effective approach to self-regulation of MFOs, which will allow to prevent MFOs from unethical behavior and practices.

The research results showed that the theory of self-regulation in microfinance industry is vulnerable and not applicable due to several reasons: (1) low level of ethical awareness of

participants – many MFOs do not grasp fully the ethics of their actions, (2) Free riding problem – participants mostly act separately and do not participate in joint actions related to the whole industry, (3) presence of mutual information asymmetry – MFOs are not fully aware what SROs are doing, and SROs do not possess the necessary information about all participants, (4) absence of meetings among participants to share best practices, (5) lack of punishment practices and cases by SROs.

Regarding the managerial implications of current study, first MFOs should consider the main unethical practices discussed in this research in their operations, trying to minimize cases of such behavior in their companies. Rather they should focus on improving efficiency of business processes and change business models constructing on more ethical principles, which will allow MFOs to improve the image of their companies and long-run sustainability from one side, and to minimize the effects of strict state regulation in forms of various limitations from other side.

Second important managerial implication from current study for MFOs should be the improvement of personnel training and education of employees to ethical standards, which will help MFOs to prevent the common ethical issues of the industry that might arise from unethical behavior of employees that directly interact with clients.

Finally, as the main goal of current study is to find effective approach to self-regulation of the industry, the results of this research might be used by MFOs to understand their role, functions and expectations from SROs, what should be their main actions directed to influence on the measures and other regulation tools that are used by the regulator. Currently, majority MFOs don't understand their role in the process of self-regulation, and therefore don't see any value in their participation to the process of regulation. This study shows what might be the most effective and workable approach to self-regulation, and how MFOs and SROs could, by clarifying their positions, jointly represent and protect the interests of participants in interaction with the regulator.

5.4. Limitations and future research

Although the findings of this research have both theoretical and practical implications, there are several limitations that should be addressed in the future research.

First, findings from both interviews and survey are based only on responses of MFOs and SRO MiR representatives, which might lead to some distorted results. The answers to the first research question are based on the opinions of MFOs' high management, and there might be bias regarding the evaluations and perceptions of ethical issues and unscrupulous practices by MFOs

representatives. As we know, all the problems discussed in this study relate to clients and mostly clients are ones that suffer from unethical behavior of MFOs.

Therefore, in order to provide more accurate findings, clients of microfinance organizations should be included in further research.

Second, the sample is taken from only SRO MiR and its member MFOs. Regardless SRO MiR is the more active in the industry and comprises MFOs with biggest share of portfolio size, however there are two other SROs (Edinstvo and Aliance), that represent remaining MFOs of the industry. Even though problem of opinion difference is not high, however for high validity and generalizability of findings, it would be better to include representatives of all SROs in further research.

Finally, the representatives of Bank of Russia were not participated in this research due to the problem of inaccessibility. The main research questions relate to such topics as ethical issues of microfinance industry that are subject for regulation, as well as, self-regulation and regulation of the industry. Since Bank of Russian is the mega-regulator of the industry and implements special policy and regulation with various limitations, the opinions and evaluations of research related topics by representatives of Bank of Russia might bring new explanations and insights to further research.

Conclusion

As the main findings were discussed and implicit answers to research questions were given in section 5.2, here we would try to summarize the main work done within this research.

As already stated, the goal of this master thesis was to explore the possibility of developing approaches to self-regulation of microfinance organizations.

For this purpose, theoretical background of regulation and self-regulation was studied first in foreign countries, then in Russia, which was aimed to determine a range of potential unethical behavior of MFOs that need regulation. The study of secondary data regarding above mentioned tasks, revealed that the most common unethical issues that exist both in Russian and in foreign countries are: low level of financial literacy of consumers, invasive marketing strategy by many MFOs, non-purposeful borrowing, lack of transparency by many MFOs, high interest rates and fines, lack of alternative sources of financing for many citizens, and lack of control on disclosure of credit conditions.

Going further two research tools were chosen: (1) in-depth interviews with SRO MiR and MFOs representatives, and (2) online survey among MFOs. The empirical results proved that the main unethical issues that need regulation are: **unscrupulous lending practices, high interest rates, lack of transparency on loan conditions, lack of flexibility by MFOs, and aggressive marketing by MFOs.**

Regarding the most effective approach to self-regulation of the industry, the results of research showed, that self-regulation of the industry without state intervention is not applicable to Russian microfinance industry due to several reasons: (1) SROs are not perceived by MFOs as institutions that could regulate the industry setting appropriate limitations, (2) SROs are perceived by participants as a commercial body, which represent the interest of the industry, while Bank of Russia mostly represent and protect interests of customers, (3) SROs do not use properly the enforcement and punishment mechanisms they have to prevent MFOs from unethical practices, (4) Low sense of unity among participants of the industry, and etc.

Hence, the more effective approach to self-regulation of current industry is **balanced approach**, which implies that SROs and Bank of Russia jointly regulate the industry – SROs mostly should represent and protect the interest of MFOs, while Bank of Russia is mostly inclined to protect the interests of customers.

However, currently SROs role is quite low, and there are several important steps (stated in section 5.2), that SROs should implement to improve their approaches to self-regulation of the industry.

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Appendix 1: Guiding questions for in-depth interviews with Russian Microfinance Center and Self-Regulated Organization MiR representatives

1. Who did initiate the creation of the RMC in 2002 and for what purpose? Were there problems at the time with the unfair behavior of individual MFOs or unethical behavior toward clients? Did RMC deal with these problems?

2. NAUMIR was established in 2006 for the political representation of microfinance interests. Did somehow exist the problem of the unfair behavior of individual MFIs at that time? Were NAUMIR and RMC engaged in this problem from 2006 to 2011?

3. How necessary was the Law of 2010? Could have the industry existed without it or not? Has this law helped to regulate the unfair behavior of MFOs and their managers? Did the law create any inconvenient or ineffective norms?

4. In 2011, the NP MiR was created - for what purpose? What kind of problems of dishonest behavior did exist at that period and how they were solved by the MiR from 2011 to 2015?

5. Can you tell the history of the development and adoption of the Code of Ethics in 2013 is of interest?

6. History of the introduction of gradual restrictions on the interest rate, indebtedness, etc. in 2015-2017. - Has SRO MiR tried to somehow prevent this regulation? What were the reasons for the regulator's decision to introduce new restrictions?

Appendix 2: Guiding questions for in-depth interviews with microfinance organizations' representatives

1. Can you, please, tell a few words about the history of the company
2. Please, describe the general characteristics of business and strategy of your company.
3. How does your company understand the ethics of relationship with a client?
4. What are the main types of unethical behavior that exist on the market and what are the reasons?
5. How does the company train and supervise its managers to avoid unethical behavior?
6. Are the efforts of SRO MiR sufficient for SRO to self-regulate the industry?
7. Is Bank of Russia regulating the industry in right direction (limiting interest rates, setting marginal indebtedness size, etc.)
8. What could SRO do to perfect its role in the process of self-regulation of the industry?

Appendix 3: Questions from survey that were used in the process of analysis

1. What kind of microfinance organization is your company?
 - MFC
 - MCC
2. In which market segment does your company operate?
 - Pay Day Loans
 - Installment loans
 - Microloans to SMEs
3. Please indicate the approximate amount of your company's loan portfolio
 - 0-150 mln rubles
 - 151-600 mln rubles
 - 601 mln rubles and more
4. What position do you occupy in the company?
 - Director
 - Deputy Director
 - Head of department
5. Please indicate the approximate share of the following components in the interest rate for the most popular microloan in your company in percentage.
 - Funding expenses
 - Operational expenses
 - Personnel expenses
 - Expenses for collection of overdue debt
 - Profit margin
6. What, in your opinion, is the unethical (unjust) interest rate level in relation to the client?
 - No more than 25% annually
 - No more than 50% annually
 - No more than 100% annually
 - No more than 200% annually
 - No more than 300% annually
 - No more than 500% annually
 - No more than 700% annually
 - No more than 800% annually
 - Any level of interest rates that the borrower will agree to is ethical (fair)
7. In which case should a client be fined?
 - Any breach of contract must be punished with a fine
 - It is necessary to apply penalties only when the MFI incurs additional costs from violation of the terms of the contract
8. How should the fine be determined?
 - The size of the fine must correspond to the additional costs of the MFI from the client violating the terms of the contract

- The penalty is an additional source of profit for MFIs and is determined by the ability of customers to pay this penalty.
9. Please indicate how much, on average, is the percentage of approved loans in percentages in your company?
 10. Please indicate in what ways your company maintains relations with the borrower?
 11. Often, accusations of unethical behavior are heard against MFOs, but it is difficult for society to understand the validity of these allegations. Please rate, as an expert, as far as the following charges are true:
(1- relevant for less than 20% of MFOs, 2 – relevant for 20-40% of MFOs, 3 – relevant for roughly half of MFOs, 4- relevant for 60-80% of MFOs, 5 – relevant for more than 80% of MFOs)
 - High interest rate
 - Lack of transparency on loan conditions
 - Not clear explanation of loan conditions to a client
 - Lending to clients with low creditworthiness
 - Unscrupulous collection practices
 - Disobedience to SROs' standards
 - Absence of option for loan prepayment
 - Absence of loan restructuring options
 - Not informing clients on upcoming payments
 - Illegal penalties on overdue loans
 - Aggressive marketing
 12. Please rate the importance of factors that may cause unethical behavior of MFOs:
(1- Absolutely insignificant, 2 - insignificant, 3 – neutral, 4- significant, 5 - Absolutely significant)
 - High competitions, fast growth and fight market share
 - Pressure of investors to demonstrate high grow indexes
 - Absence of regular training personnel
 - Ineffective compensation system of managers
 - Low financial literacy of population
 - Absence of alternatives for low-income people to get loans
 - Absence of competitions in many regions
 13. In what ways, in your opinion, can the behavior of those MFIs that behave insufficiently ethically be improved?
 14. Please rate how effective is the SRO, of which your company is a member, carrying out its activities in each of the following areas?
(1- Absolutely not effective, 2 – not effective, 3 – in half cases ineffective, 4- effective, 5 - Absolutely effective, 0- do not possess information)
 - Assistance to increase legal literacy of population
 - Assistance to increase financial literacy of population
 - Fight against “grey” market
 - Responding to costumers' complaints and protecting their rights
 - Assistance to increase of transparency by MFOs
 - Assistance MFOs finding financing

- Development of ethical standards of conduct for MFOs
 - Participation in creation of legislation that represents rights of MFOs
 - Regular checkups to prevent unethical practices of MFOs
 - Assistance to MFOs with training of managers to ethical standards
15. Please rate how each of the following constraints affects the financial stability of an MFOs:
- (1- Absolutely negative, 2 – negative, 3 – average, 4- positive, 5 - Absolutely positive)
- Unified limitation of the borrower's debt limit (2.5x, 2x, 1.5x)
 - Limitation of the daily interest rate of 1.5% (from 01.07.2019 1% per day)
 - Limitation of the full cost of consumer loan (FCC)
 - Limit on the amount of the penalty (not more than 20% per annum or 0.1% per day)
16. In general, how much do you agree with the Bank of Russia policy on the regulation of the microfinance market?
- (absolutely disagree, 2 – disagree, 3 – average, 4- agree, 5 - absolutely agree)
17. Who should regulate the market for microloans?
- Self-Regulated Organizations
 - State regulator
 - Harmonized balanced joint work of these two bodies
18. If you have additional comments about the issues discussed above, please write them.